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VINSON-TRAMMELL ACT REPEAL OR REVISION

MONDAY, FEBRUARY 25, 1980

U.S. SENATE,
PROCUREMENT POLICY AND REPROGRAMING SUBCOMMITTEE,
COMMITTEE ON ARMED SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2 p.m., in room 235, Russell Senate Office Building, Hon. Robert Morgan, presiding.

Present: Senator Morgan.

Committee staff present: Rhett B. Dawson, counsel; George H. Foster, Jr., Edward B. Kenney, professional staff members; John C. Roberts, general counsel; John T. Ticer, chief clerk; Christine E. Cowart, assistant chief clerk; and Karen A. Love, clerical assistant.

Also present: John Stirk, assistant to Senator Morgan; Frank T. J. Bray, assistant to Senator Humphrey; Michael Hastings, assistant to Senator Cohen; and Mike Donley, assistant to Senator Jepsen.

[The bills S. 1687, S. 2232, and S. 2331 follow:]

[S. 1687, 96th Congress, 1st Session]

A BILL To amend title 10, United States Code, to eliminate certain limitations imposed on excess profits arising from any contract with any military department of the United States for the construction or manufacture of all or part of any complete aircraft or any contract with the Secretary of the Navy for the construction or manufacture of all or part of any complete naval vessel, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 2382 of title 10, United States Code, is repealed.

(b) The table of sections at the beginning of chapter 141 of title 10, United States Code, is amended by striking out the item re'ating to section 2382.

SEC. 2. (a) Section 7300 of title 10, United States Code, is repealed.

(b) The table of sections at the beginning of chapter 633 of title 10, United States Code, is amended by striking out the item relating to section 730.

SEC. 3. (a) Sections 7342 and 7343 of title 10, United States code, are repealed.

(b) The table of sections at the beginning of chapter 635 of title 10, United States Code, is amended by striking out the items relating to sections 7342 and 7343.

SEC. 4. The provisions of the first section and of section 2 of this Act shall apply to contracts entered into after September 30, 1976.

[S. 2232, 96th Congress, 2d Session]

A BILL To amend section 2382 of title 10, United States Code, to exempt contracts of $1,000,000 or less

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 2382(g)(2) of title 10, United States Code, is amended by striking out "$10,000" and inserting in lieu thereof "$1,000,000".

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[S. 2331, 96th Congress, 2d Session]

A BILL To amend title 10, United States Code, to eliminate certain limitations imposed on excess profits arising from any contract with any military department of the United States for the construction or manufacture of all or part of any complete aircraft or any contract with the Secretary of the Navy for the construction or manufacture of all or part of any complete naval vessel, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Vinson-Trammell Act Amendments of 1979".

SEC. 2. Section 2382 of title 10, United States Code is amended to read as follows:

"§ 2382. Noncompetitive national defense contracts: excess profits

"(a) Secretary of Defense may not make a noncompetitive national defense contract unless the contractor agrees—

"(1) to pay any excess profit to the United States;

"(2) to make no division of any contract or subcontract for the purpose of evading this section; and

"(3) to make no first tier subcontract unless the subcontractor agrees to the conditions set forth in this subsection.

"(b) For the purposes of this section—

"(1) The term 'noncompetitive national defense contract' means a negotiated contract made by the Department of Defense—

"(i) for the acquisition of property, other than real property in being and leaseholds and other interests therein, or services through purchase with funds appropriated under Appropriation Acts;

"(ii) for the direct benefit and use of programs for military production or construction, military assistance to any foreign nation; and

"(iii) the price of which exceeds $5,000,000 and is not based on adequate price competition, catalog or market prices of commercial items sold in substantial quantities to the general public or prices set by law or regulation; or the final price of which includes more than $5,000,000 attributable to contract changes or modifications.

"(2) The term 'noncompetitive subcontract' means a subcontract at the first tier under a noncompetitive national defense contract the price of which meets the prerequisites in subsection (b) (1) (iii) of this section.

"(3) The term 'profit' means the excess of the amount received or accrued under a contract or subcontract over the costs paid or incurred with respect thereto and allocable thereto.

"(4) The term 'excess profit' means so much of the profit of a national defense noncompetitive contract or noncompetitive subcontract thereunder completed within the taxable year, as the Secretary of Defense determines to be greater than 15 percent of the total final contract price less—

"(A) any amount earned under performance incentive provisions of the contract or subcontract; and

"(B) any amount earned under value engineering and other similar provisions for sharing of cost savings resulting from changes in means, methods and materials for performance of work.

"(c) A contract or subcontract shall be deemed completed when the last unit of supplies thereunder has been delivered or the services called for therein have been completed.

"(d) The Secretary of Defense shall prescribe regulations to carry out the purpose of this Act. Such regulations shall provide standards necessary to maintain a minimum level of paperwork and a minimum level of cost of compliance with the requirements of this Act. When an excess profit is found owing the Secretary of Defense shall allow credit for any Federal income taxes paid or to be paid on the excess profit. If with respect to contracts and subcontracts with the Department of Defense for the purposes described in subsection (b) (1) (ii), a contractor or subcontractor has a net loss on the aggregate of such contract and subcontracts completed in a taxable year, the loss shall be allowed as a credit against any excess profit for the next succeeding four taxable years.

"(e) When paid to the United States, an excess profit becomes the property of the United States. The surety under the contract is not liable for its payment.

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"(f) For the purposes of this section, any authorized representative of the Secretary of Defense who is an employee of the United States Government shall have the right, until the expiration of 3 years after final payment under a noncompetitive national defense contract or first tier subcontract thereunder to examine all books, records, documents, and other data of the contractor or subcontractor related to the negotiations, pricing, or performance of such contract or subcontract.

"(g) If the amount of profit required to be paid to the United States under this section is not voluntarily paid, the Secretary of Defense may collect the same by (1) setoff against any amount due to the contractor or subcontractor from the United States; and (2) such other method as is provided by law.

"(h) This section does not apply to—

"(1) a subcontract under a noncompetitive national defense contract that is not a noncompetitive subcontract; or

"(2) any contract or subcontract as to which the Secretary of Defense or a designee, determines that the requirements of this section may be waived. The Secretary of Defense shall report to Congress no later than March 15 of each year on all instances in which this authority was exercised during the preceeding calendar year.".

SEC. 3. To provide information that will aid Congress in its oversight responsibilities and to provide accountability in implementing this Act, the Secretary of Defense shall prepare an annual report, which shall be furnished to the Congress at the time of submission of each annual fiscal budget, beginning with the annual fiscal budget for the first fiscal year after the enactment of this Act. The annual report shall include, but not be limited to (a) the total dollar amount voluntarily repaid or assessed by the Secretary as excessive profit under this Act; (b) the administrative and other costs incurred by the Department of Defense in carrying out this Act; (c) actions taken by the Secretary to reduce, to the maximum extent practicable, the paperwork requirements of business concerns in complying with this Act; and (d) such other data as may be helpful in keeping Congress and the public fully and currently informed about the administration of the Act. In addition, beginning with the fifth year, the annual report shall contain data with respect to the cost effectiveness of this Act, and recommendations with respect to extension of the term provided in section 5(b) hereof.

SEC. 4. (a) Section 7300 of title 10, United States Code is repealed.

(b) The table of sections at the beginning of chapter 633 of title 10, United States Code is amended by striking out the item relating to section 7300.

(c) The table of sections at the beginning of chapter 141 of title 10, United States Code is amended by substituting the following for the item relating to section 2382:

"2382. Noncompetitive national defense contracts: excess profits.".

SEC. 5. (a) Sections 4(a) and 4(b) of this Act take effect as of October 1, 1976.

(b) Sections 2 and 4(c) of this Act take effect as of October 1, 1976 but shall apply only to contracts and subcontracts entered into from the close of one hundred and twenty days after the date of enactment of this Act until the close of sixty months after the date of such enactment.

OPENING STATEMENT BY SENATOR MORGAN, CHAIRMAN

Senator MORGAN. I will call our subcommittee to order.

If you will permit me, I will make a very short statement, so that we will know in just what direction the subcommittee is going to be headed.

The Vinson-Trammell Act, as it presently exists, began as a part of the Vinson-Trammell Naval Parity Act of 1934. It began as Public Law 73–135 of March 27, 1934. It was amended by Public Law 74–4 on June 25, 1936, and was further amended by Public Law 76–18 on April 3, 1939.

The profit limitations are currently contained in sections 2382 and 7300 of title X of the United States Code. Current regulations relating to the application of the profit limitations are contained in parts

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16 and 17 of 26 Code of Federal Regulations dated 1939. Part 16 relates to Army and Air Force contracts for aircraft. Part 17 relates to Navy contracts.

Congressman Carl Vinson, of Georgia, is credited with being the father of the Profit Limitation Act. In reality, it was a creation of Charley Tobey, Congressman from New Hampshire.

When the Vinson-Trammell Parity Act was under consideration in the House of Representatives, Congressman Tobey proposed an amendment as follows:

> *Provided, however,* that no such appropriation shall be used for any contract with steel or aircraft or shipbuilding firms or corporations unless the said firm or corporation shall agree to limit its profit on such Government contract to 10 percent of the gross of the contract.

When the amendment was proposed, Mr. Vinson attempted to avoid it by raising a point of order. He failed in this and was reluctantly forced to accept the amendment.

As finally passed, the amendment proceeded to create problems in Navy procurement. Attempts were made to correct the problems and at least one attempt, a bill passed in 1936, was introduced by Carl Vinson.

The so-called Vinson-Trammell Act differs from the Renegotiation Act, which we put to rest earlier, in several ways: (1) it places a fixed limit on profits and is administered by IRS; (2) its profit limits is much lower than the Renegotiation Board and the Court of Claims have generally allowed in renegotiation cases; (3) there are no statutory factors under which a strict profit limit can be eased to recognize special circumstances of a contractor or an industry; (4) liability is computed on the basis of contract actually completed during a taxable year, and not on the basis of receipts or accruals; (5) there are no significant exceptions, except for contracts under $10,000 and for scientific equipment.

The two sections of the codification of the act differ in profit limitation: 12 percent for aircraft and 10 percent for vessels.

Under the vessel section, net loss in a particular year can be offset against excess profits earned in the following taxable year.

Under the aircraft section, not only can net loss be offset but also any deficiency in profit of less than 12 percent over the following 4 taxable years.

There is considerable agreement that the Vinson-Trammell Act is unworkable in its present form and as implemented by IRS regulations currently in effect.

Today we will hear from Senators Cranston and Lugar, who have introduced a bill, S. 1687, to repeal the act.

We will also hear from Senator Pell, who has introduced a bill, S. 2232, to raise the $10,000 exemption figure. And we will have testimony from Mr. Patterson, who has introduced a bill to substantially revise the act: that is H.R. 5433. I intend to introduce Congressman Patterson's bill here in the Senate, not because I necessarily espouse all of its provisions, but because I view it as a viable alternative which we should have officially before the subcommittee as we consider this matter.

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[Subsequently Senator Morgan introduced the same bill, S. 2331, in the Senate.]

We will address H.R. 5433 today as if it were before us.

We will also hear from Senator Mathias, Jerome Kurtz, and Dale W. Church.

With that opening statement, we will proceed to recognize our distinguished colleague from Rhode Island, Senator Pell, who has introduced one of the bills that we are considering.

STATEMENT OF HON. CLAIBORNE PELL, A U.S. SENATOR FROM THE STATE OF RHODE ISLAND

Senator PELL. Thank you very much indeed, Senator Morgan. I appreciate immensely your giving me this opportunity.

Last month, as you mentioned, I introduced legislation to streamline enforcement of the Vinson-Trammell Act.

As you pointed out, there is urgent reason to consider what action can be taken in order to prevent real hardships to smaller companies competing for defense contracts.

As we all know, Vinson-Trammell was automatically brought back to life when the Congress allowed the Renegotiation Board's authority to expire last April. The last time anyone had to contend with this vestigial law was over 25 years ago, and I am sure that many of my colleagues shared my dismay upon discovering how arbitrary and cumbersome Vinson-Trammell really is.

In my view, the Vinson-Trammell Act is a rigid, mechanical law which will result in an absolute bureaucratic nightmare if it is enforced as written. Where the renegotiation process was comparatively flexible, Vinson-Trammell requires an automatic rebate to the Treasury of all profits over 10 percent and 12 percent, respectively, on ship contracts and planes.

In order to recoup these excess profits, data will have to be filed with Internal Revenue Service on every ship and plane subcontract over $10,000. It has been estimated that IRS would have to hire a small army of bureaucrats, at a projected cost to the taxpayer of approximately $35 million a year, just to keep up with the mountain of paper Vinson-Trammell will generate.

At a time when all our constituents are clamoring for a reexamination of Government regulation, I cannot think of a single, more unproductive exercise of over-regulation than that which will result from the enforcement of Vinson-Trammell.

I am especially concerned about the negative impact this law will have on smaller companies competing for defense contracts.

The Renegotiation Board's enforcement practices were targeted toward the larger defense contracts. Gross defense sales under $1 million, along with certain categories of sales, were exempt from renegotiation entirely. The Board was also required to take into account, when considering whether a firm had realized excess profits, the size and character of the business, the net worth of the contractor and the risk assumed on the particular contract.

The Vinson-Trammell Act contains none of this flexibility; smaller companies will be subject to the same automatic and mechanical defini-

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tion of profits as the Nation's largest defense contractors, regardless of the extent of subcontracting or reasonableness of the contractors' costs and profits.

Apart from the rigid application of profit limitations, the harshest impact of Vinson-Trammell on smaller companies will be the cost of furnishing IRS with the profit data required by the act.

Whereas, renegotiation required firms to report sales and profits only if they exceeded $1 million, Vinson-Trammell requires a separate audit report to be filed on each ship or plane contract over $10,000.

The proposed IRS regulations implementing Vinson-Trammell require documented disclosure of cost and pricing data on each contract, together with data on how the contractor derived his profit, computed according to a complicated accounting formula. I believe that the added costs and burden of complying with these requirements will effectively prohibit many smaller companies from competing for defense contracts.

I have heard from a number of small businessmen in my State concerned about the impact Vinson-Trammell will have on their firms. They have pointed out that while over 60 percent of all DOD contracts are awarded to sole-source suppliers, the smaller subcontracts are usually highly competitive and that competition keeps their prices and profits in line.

I have concluded that as a starting point the simplest way of easing the impact of Vinson-Trammell on smaller companies is to raise the reporting requirement from the present $10,000 to $1 million. The figure of $10,000 may well have been realistic for enforcement purposes 45 years ago but it hardly seems a realistic figure today.

My approach does not deal with many of the other problems created by Vinson-Trammell, such as the very obvious inequity in enforcing profit limitation with respect to ship and plane contracts, but not other types of defense contracts.

My proposal does not affect the profit limitations on contracts over $1 million, still leaving the question of the occasional unfairness which may result from the mechanical application of automatic profit limitations.

These questions suggest the need for a comprehensive revision of the entire law, a process which may involve some time because of the strong views which exist on both sides of the profit limitation question.

I could not support an outright repeal of Vinson-Trammell as another bill you are considering today would accomplish. Some type of reasonable profit limitation is essential, as the Congress has wisely recognized since the 1930's. The flow of defense dollars is among the most inflationary of all types of Government spending and we must do well by the taxpayers and seek to eliminate any waste connected with defense spending.

As I mentioned earlier, over 60 percent of all defense contracts are awarded on a sole-source basis. This lack of true competition, as well as the degree of concentration in many defense industries, creates the opportunity for excessive profits to be realized.

Contractors can and do insist on very high prices in certain circumstances, and with the rapid surges in defense purchases that occur frequently, some sectors of the defense industry do enjoy a seller's

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market. Reasonable profit limitation is a deterrent to contractors and a guarantee to taxpayers that our defense dollars are being spent wisely.

I hope my colleagues will share my view of the importance of reforming Vinson-Trammell, but not throwing it out of the window. From the standpoint of effective procurement policy, which is your subcommittee's major concern, it simply does not make sense to enforce a law which will create an enormous hardship for the smaller contractors who are the backbone of our procurement system.

For the taxpayers, it makes equally little sense for the Internal Revenue Service to waste tax dollars collecting pieces of paper and then hire more bureaucrats to keep track of the reports.

My approach to the problem is a simple and direct way of streamlining the enforcement of Vinson-Trammell, and I believe that by quickly enacting it we can avoid at least some of the major problems connected with the enforcement of this old law.

Thank you very much for giving me this opportunity.

Senator MORGAN. Thank you, Senator Pell, for a very clear and succinct statement.

I understand you have other commitments. We are just beginning today, so we will keep you informed as to the progress we are making and where we will begin.

Senator PELL. Thank you very much indeed for letting me be with you.

Senator MORGAN. Congressman Patterson, we are glad to have you with us.

We thank you for the work you are doing on this. As I said in my statement, we are going to proceed as if your bill were before the subcommittee. I do plan to introduce it when the Senate opens tomorrow, so that we will have it before the subcommittee.

STATEMENT OF HON. JERRY M. PATTERSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. PATTERSON. Thank you very much.

Mr. Chairman and members of the subcommittee, I appreciate your invitation to testify at this hearing concerning the Vinson-Trammell Act of 1934 and hope that this testimony will be helpful to you as you determine what revisions to the act may be most appropriate.

As you know, the Renegotiation Board's contract review powers expired on September 30, 1976, and Congress abolished the Board by refusing to fund it beyond March 31, 1979. As a result, Vinson-Trammell became effective.

If Congress does not amend the existing act before April 15, which is less than 2 months away, defense contractors will be required to file with the IRS.

The IRS' proposed regulations reflecting the requirements of the 1934 act will subject almost all DOD contractors and subcontractors of naval vessels and military aircraft to reviews for every income taxable year beginning after October 1, 1976.

These proposed regulations, appearing in the October 26, 1979, Federal Register, pages 61611 through 61618, refer to aircraft and ship-

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building contracts and subcontracts in excess of $10,000. They will cover contracts for the "construction or manufacture of all or a part" of a new complete naval vessel or military aircraft.

A "portion," as defined under the proposed rules, constitutes "any material or article that forms part of a complete naval vessel or military aircraft that has been furnished under a mutual understanding that it is to form such a part."

Every contractor and subcontractor will be required to make available for inspection and audit at all times by DOD its manufacturing plants and books of its "plants, affiliates and subdivisions."

The urgency of bringing Vinson-Trammell up to date can best be illustrated by describing the impact of imposing 1934 contracting requirements on defense procurement in the 1980's.

1. IRS would be responsible for implementing the existing Vinson-Trammell Act. In order to fulfill this responsibility, IRS has indicated that it must hire almost 1,500 new employees, at a cost of roughly $35 million.

2. Under the 1934 act covering aircraft and shipbuilding contracts in excess of $10,000, more than 10,000 additional defense contract audit reports would be filed every year.

3. The $10,000 floor will subject small businesses to review under Vinson-Trammell. The effect will be to force these businesses into a paperwork jungle.

4. Annual costs of administration and compliance could easily exceed $120 million.

5. The requirements of the 1934 act apply to domestic as well as foreign subcontractors. McDonnell-Douglas' F–15 contract involves some assembly and parts manufactured in Japan; Canada supplies some of the parts under Lockheed's P–3—Navy patrol-aircraft—contract; and the C–130 and the C–141—Air Force cargo transfer—projects involve some foreign coproduction in Belgium and Holland.

Foreign coproduction is not exempt under the 1934 Vinson-Trammell Act; therefore, foreign subcontractors will be required to accept the terms of the Vinson-Trammell Act, including inspection and audit of their records by the U.S. Government before the subcontract can be awarded.

I introduced on the House side H.R. 5433,[1] which is an alternative to both the 1934 Vinson-Trammell Act and to proposals for the repeal of such act.

Resuscitating Vinson-Trammell in its present form cannot be justified. As an alternative to the 1934 act, I draw your attention to H.R. 5433. The thrust of this proposal is to repeal unworkable provisions of the existing act and to replace those provisions with a system that can be effective and which will exempt small contractors.

Mr. Chairman, with your indulgence, maybe we will draw out the provisions of the proposal by considering the following questions.

1. How would H.R. 5433 amend the 10 percent and 12 percent profit limitations, respectively, on shipbuilding and aircraft contracts in excess of $10,000?

H.R. 5433 repeals those provisions of Vinson-Trammell. In place of those standards established in 1934, the bill sets a 15-percent profit

[1] Introduced in the Senate by Senator Morgan, See S. 2331.

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ceiling on noncompetitive Defense Department contracts and noncompetitive first-tier subcontracts in excess of $5 million; 65 percent of Defense Department contracts are awarded on a noncompetitive basis; that means 35 percent are competitive and probably need no review. The 65 percent awarded on a noncompetitive basis represents 75 percent of the defense contracting dollars.

If H.R. 5433 is enacted, 7 percent of our defense contracts will be subject to Vinson-Trammell, representing about 57 percent of the defense contracting budget. (See sec. 2(b) (1) and (2).)

Section 2(b) (3) clarifies that a noncompetitive contract is one the price of which is not based upon adequate price competition, catalog or market prices of commercial items sold in substantial quantities to the general public or prices set by law or regulation.

The definitions of "adequate price competition" and "commercial articles" are contained in 10 U.S.C. 2306(f) and in Defense Acquisition Regulations (DAR) 3.807.7.

2. Will the profit policy of H.R. 5433 be imposed retroactively?

The new 15-percent ceiling will not be imposed retroactively. Section 4 of H.R. 5433 repeals the 10-percent Vinson-Trammell limit for shipbuilding contracts effective October 1, 1976, the date on which the Renegotiation Board's authority to review new contracts expired.

Section 5 would repeal the 12 percent Vinson-Trammell aircraft contract profit ceiling also as of October 1, 1976; however, according to section 5(b), the excess profit policy of H.R. 5433 "shall apply only to contracts and subcontracts entered into from the close of 120 days after the date of enactment of this act until the close of 60 months after the date of such enactment." This language states plainly that the profit limitation program will not apply retroactively; it will be prospective and will sunset at the end of 5 years.

3. Will H.R. 5433 penalize efficient or outstanding performance by a contractor?

H.R. 5433 provides at section 2(b) (4) (A) and (B) that deductions from profits in excess of 15 percent shall be allowed for amounts earned under performance incentive and value engineering provisions and "other similar provisions for sharing of cost savings resulting from changes in means, methods and materials for performance of work."

These provisions grant contractors ample opportunity to be rewarded for efficiency and outstanding performance. The amounts earned can be found on the contract form.

Computing excess profit

Example:	
Contract price	$6,000,000
Profit	1,200,000
15 percent (allowable)	900,000
Excess	300,000
Assume that PI plus VE equals (allowable)	200,000
Excess profit	100,000

4. Some contractors argue that the Vinson-Trammell Act was enacted as a consequence of some corporations' greed in World War I when the Government had neither the time nor the staff to investigate proposed costs of performance. They claim that through "Truth in Negotiations," "Cost Accounting Standards," and the mandatory cost prin-

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ciples in the Defense Acquisition Regulations (DAR), DOD's ability to negotiate a reasonable cost is quite good. Therefore, they conclude that a simple repeal of Vinson-Trammell makes more sense.

I have had a good deal of correspondence with the Department of Defense and will briefly cite a few of those at this point.

In his September 25, 1979, response to one of my inquires, the Deputy Under Secretary for Acquisition Policy of the Defense Department said:

> Your letter notes that the type of legislation that you propose has been opposed on the ground that existing procurement safeguards make unnecessary any excess profit limitations on noncompetitive defense contracts. Laws such as the Truth in Negotiations Act, 10 U.S.C. 2306(f), and the Cost Accounting Standards Act, 50 U.S.C. App. 2168, help the Government substantially to secure fair and reasonable prices in noncompetitive procurements. These statutory tools, however, will not prevent the occurrence of unintended excessive profits.

A DOD letter to the Office of Management and Budget dated July 5, 1979, regarding Vinson-Trammell states:

> A statutory profit limitation is not needed for national defense contracts, the price of which is based upon adequate price competition, catalog or market prices of commercial items sold in substantial quantities to the general public, or prices set by law or regulation.
>
> A statutory profit limitation is needed, however, to deal with situations where a contractor or subcontractor exploits its sole-source position to demand much higher prices than would be sought in a commercial environment. Often these sole-source prices are inflated by estimating on a worst-case basis instead of assuming reasonable economy and efficiency, or by including cost contingencies for highly unlikely events, such as catastrophic test failures or dramatic business downturns.
>
> Existing statutory tools are not designed to prevent an unreasonable profit in these sole-source situations. The contractor or subcontractor will have complied with the Truth in Negotiations Act, 10 U.S.C. 2306(f) in disclosing and certifying the proposed cost and in presenting such cost in conformity with the Cost Accounting Standards Act, 50 U.S.C. App 2168.
>
> Nothing in these laws forces a contractor to exercise the same measure of reasonableness in estimating as would be applied in a competitive situation. In those situations where we cannot realistically negotiate a fair price at the outset, we need a statutory profit limitation to recapture any excess profit realized when the contract is completed.

Additionally, the Defense Department wrote me on December 21, 1979, saying:

> We believe the functions of the GAO and the DCAA would not prevent excessive profits from accruing to a contractor. Negotiated contract prices are based on a contractor's cost or pricing data and the judgmental factors applied in projecting from the data to the estimated contract cost.
>
> Cost or pricing data, being factual, can be audited by agencies such as GAO and DCAA. The judgmental factors, however, are not auditable and must be resolved through negotiation. Existing laws would not preclude a situation where a contractor would exploit a sole-source marketing position to demand higher prices or profits than would be sought in a competitive environment, or where poor or hurried negotiations would result in a contractor realizing an excessive profit.

5. Contractors raise the following question: If typical profits on cost-type contracts range from 6.5 percent to 7.5 percent and from 12 percent to 13 percent for firm fixed-price contracts, then why should a 15-percent or any other ceiling be imposed?

The answer is that there is a need to capture unconscionable profits from sole-source providers in typical cases. Furthermore, the 15-per-

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cent ceiling is reasonable and will give contractors an incentive to do business with the Government, judged by their own statement of 6.5 to 12 percent in their statement to me.

Also, with the setting of a $5 million floor we will be looking at 7 percent of DOD noncompetitive contracts, focusing attention on the largest awards. Again, that is 57 percent of the defense contract dollars.

In March 1979 the House General Oversight and Renegotiation Subcommittee held hearings on the Renegotiation Act, at which time Vinson-Trammell reform was also discussed.

My distinguished colleague and fellow Californian, Congressman Pete McCloskey, succinctly stated the issue when he remarked that the object of revising Vinson-Trammell is not to prevent the recapture of excess profits but "to end a system to recapture excess profits which has not been effective, which has not been efficient and which has really hit small businesses and not the large."

H.R. 5433 is a workable and effective solution.

6. What is the impact of setting the filing floor at $1 million, rather than $5 million? This question was considered when the legislation was being drafted.

A. With a $1 million floor, DOD's workload would quadruple, as follows:

Workload (contractual actions per year)

$1 million floor: 8,000.
$5 million floor: 2,000—800 prime contracts; 600 1st-tier subcontracts; 600 contract changes, aggregating more than $5 million.

B. With a $1 million floor, DOD's annual cost of implementation may exceed $1.6 million, not including compliance costs to contractors and subcontractors:

Implementation cost (annual)

$1 million floor: $1.6 million (at least).
$5 million floor: $1 million (includes DOD and contractor compliance costs).

C. With a $1 million floor, DOD's staff needs will increase substantially:

Staff

$1 million floor: 46 (includes 25 auditors).
$5 million floor: 13 (includes following positions: rulemaking, 4; auditing, 6; and administrative support 3.

D. With a $1 million floor covering 8,000 contracts, each year it is estimated that 10 percent of such contracts will involve small businesses. SBA staff indicate that very, very few small businesses are awarded DOD contracts in excess of $5 million.

While some small businesses may be subject to the profit limitation under H.R. 5433, it appears that this will occur less than 1 percent of the time on 2,000 contracts:

Small business impact

$1 million floor: 10 percent of 8,000 contracts.
$5 million floor: Less than 1 percent of 2,000 contracts.

7. Will H.R. 5433, if enacted, be implemented by another agency resembling the Renegotiation Board?

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H.R. 5433 would require reviews of DOD's largest noncompetitive contracts. DOD will implement the act and the reviews can be conducted without hiring a large additional staff. The excess profit determination involves no subjective analysis such as that engaged in by the Renegotiation Board. My recollection is that some 13 new staffers would be necessary at the $5 million level.

8. Would H.R. 5433 subject foreign military sales (FMS) to Vinson-Trammell?

Section 2(b)(1) of H.R. 5433 sets the criteria for contracts subject to the 15-percent profit ceiling. One requirement is that the acquisitions be made with appropriated funds. See section 2(b)(1)(i).

The history of the Vinson-Trammell Act reveals its application only to contracts paid for by appropriated funds. Prior to 1972, foreign military sales were sometimes paid for by appropriated funds and later the foreign government would reimburse DOD. Since that time, however, DOD has instituted what is called "direct-site funding."

Under this procedure, a revolving fund is created for a foreign government; that government deposits funds in the account and contracts are paid for through the fund; therefore, FMS do not involve appropriated funds and are not subject to H.R. 5433.

For exceptions to direct-site funding which may occur, as well as for other situations calling for exemptions to Vinson-Trammell, H.R. 5433 at section (2)(h)(2) grants the Secretary of Defense or a designee waiver authority.

9. Should H.R. 5433 apply to large noncompetitive contracts of other agencies as well?

Since the date when my bill was introduced, I understand that the OMB conducted a survey of the agencies to determine whether or not their contracts should be covered under H.R. 5433. The last response to the survey was filed on February 14, and the results of that survey indicate unanimous agreement by the agencies against Vinson-Trammell coverage of their contracts.

While I do not have further details about this survey, I am sure that OMB will gladly provide them to the committee.

Mr. Chairman, that concludes my testimony.

I respectfully urge that your subcommittee consider H.R. 5433 as an alternative to the 1934 Vinson-Trammell Act.

I appreciate the honor of being able to present my views before this distinguished body.

Thank you.

Senator MORGAN. Thank you. You have done a good job of covering it, especially with your good questions and good answers.

Mr. PATTERSON. In that way I do not leave anything unanswered.

Senator MORGAN. Could you furnish us, for the record, copies of the letters that you quote from?

Mr. PATTERSON. Yes, Senator, I will.

Senator MORGAN. I think that will be helpful. Other than that, I think you have adequately covered it.

[The information follows:]

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JULY 5, 1979.

MR. FRANK RAINES,
Program Assistant Director for Economics in Government, Office of Management and Budget, New Executive Office Building, Washington, D.C.

DEAR MR. RAINES: This letter is in response to a request by Mr. Jim Jordan of your staff for a statement of the Department of Defense regarding the need for and administration of a profit limitation that would be substituted for the existing provisions of the Vinson-Trammell Act.

A statutory profit limitation is not needed for national defense contracts, the price of which is based upon adequate price competition, catalog or market prices of commercial items sold in substantial quantities to the general public, or prices set by law or regulation. A statutory profit limitation is needed, however, to deal with situations where a contractor or subcontractor exploits its sole source position to demand much higher prices than would be sought in a commercial environment. Often these sole source prices are inflated by estimating on a "worst case" basis instead of assuming reasonable economy and efficiency, or by includng cost contingencies for highly unlikely events such as catastrophic test failures or dramatic business downturns.

Existing statutory tools are not designed to prevent an unreasonable profit in these sole source situations. The contractor or subcontractor will have complied with the Truth in Negotiations Act (10 U.S.C. 2306(f)) in disclosing and certifying the proposed cost and in presenting such cost in conformity with the Cost Accounting Standards Act (50 U.S.C. App 2168). Nothing in these laws forces a contractor to exercise the same measure of reasonableness in estimating as would be applied in a competitive situation. In those situations where we cannot realistically negotiate a fair price at the outset, we need a statutory profit limitation to recapture any excess profit realized when the contract is completed.

We would have no objection to administering a profit limitation statute that is limited in application to large Department of Defense negotiated contracts and which utilizes an objective standard for determining excess profits.

Sincerely,

ROBERT F. TRIMBLE,
Director, Contracts and Customs Acquisition.

OFFICE OF THE UNDER SECRETARY OF DEFENSE,
Washington, D.C., September 25, 1979.

HON. JERRY M. PATTERSON,
U.S. House of Representatives,
Washington, D.C.

DEAR MR. PATTERSON: This is in reply to your letter of September 12, 1979, which requested comments on a legislative proposal which would make certain revisions to the Vinson-Trammell Act of 1934.

Under your draft bill, profit limitations would apply only to large, noncompetitive contracts. Excessive profits would be determined using objective criteria with provision for offset of losses against profits. Amounts of profit earned as performance incentives or for value engineering achievements would be exempt from the profit limitations.

Your letter notes that the type of legislation that you propose has been opposed on the ground that existing procurement safeguards make unnecessary any excess profit limitations on noncompetitive defense contracts. Laws such as the Truth-in-Negotiations Act (10 U.S.C. 2306(f)) and the Cost Accounting Standards Act (50 U.S.C. App. 2168) help the Government substantially to secure fair and reasonable prices in noncompetitive procurements. These statutory tools, however, will not prevent the occurrence of unintended excessive profits.

You also requested our review of the definitions for "noncompetitive" contracts. Your draft bill utilizes the criteria now set forth in the Truth-in-Negotiations Act. These criteria appear to be appropriate for this purpose also. In our view, for the purposes of the Truth-in-Negotiations Act a follow-on contract would be considered competitive only if the price was based on adequate price competition.

We have provided the foregoing comments in order to assist you in the formulation of your proposals. Accordingly, these comments should not be understood as expressing our views on the merits of these proposals.

Sincerely,

DALE W. CHURCH,
Deputy Under Secretary (Acquisition Policy).

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OFFICE OF THE UNDER SECRETARY OF DEFENSE,
Washington D.C., December 21, 1979.

Hon. JERRY M. PATTERSON,
U.S. House of Representatives,
Washington, D.C.

DEAR Mr. PATTERSON: This is in reply to your letter of December 11, 1979, which requested comments as to whether the functions of the General Accounting Office (GAO) and the Defense Contract Audit Agency (DCAA) would preclude excessive profits under defense contracts and on the feasibility of a straight repeal of the Vinson-Trammell Act.

We believe the functions of the GAO and the DCAA would not prevent excessive profits from accruing to a contractor. Negotiated contract prices are based on a contractor's cost or pricing data and the judgmental factors applied in projecting from the data to the estimated contract cost. Cost or pricing data, being factual, can be audited by agencies such as GAO and DCAA. The judgmental factors, however, are not auditable and must be resolved through negotiation. Existing laws would not preclude a situation where a contractor would exploit a sole source marketing position to demand higher prices or profits than would be sought in a competitive environment, or where poor or hurried negotiations would result in a contractor realizing an excessive profit.

It would not be appropriate for us to comment on the feasibility of a straight repeal of the Vinson-Trammell Act prior to Office of Management and Budget approval of our report on the repeal bills. Accordingly, our comments should not be understood as expressing our views on the merits of either H.R. 5433 or H.R. 3254.

Sincerely,

ROBERT F. TRIMBLE,
Acting Deputy Under Secretary (Acquisition Policy).

Senator MORGAN. Congressman, since this is the opening day, we will just go ahead with your statement. If we get further and deeper into it and we need to discuss it with you again, we will try to get together.

Mr. PATTERSON. Thank you.

If I could add one thing, under the proposal that I have made, we estimate that 42 percent of the contracts, if this bill, H.R. 5433, were in place, would either be contracts awarded on a competitive basis or would be subject to the bill, subject to the review, while 58 percent would not be. They would, of course, be the smaller noncompetitive contracts. That would mean that 82 percent of the contract dollars would be subject to either the competitive process or the review provided in the bill.

Senator MORGAN. Under your bill?

Mr. PATTERSON. Yes, sir.

Senator MORGAN. Thank you very much.

Mr. PATTERSON. Thank you, Mr. Chairman.

Senator MORGAN. I thought I observed Senator Mathias coming in.

Senator, we have heard from Senator Pell. You have just heard Congressman Patterson. This is our opening day of hearings on the Vinson-Trammell Act. So, we will be glad to hear from you.

STATEMENT OF HON. CHARLES McC. MATHIAS, JR., A U.S. SENATOR FROM THE STATE OF MARYLAND

Senator MATHIAS. Mr. Chairman, I would like to make a brief statement and take advantage of the offer you have just made. As the record unfolds and you get more information, it might be useful to supplement it; but I do appreciate the opportunity to testify before the Armed Services Subcommittee on Procurement Policy and Reprograming.

I appear in support of S. 1687, introduced by Senator Lugar from *Indiana and cosponsored* by Senator Cranston from California.

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Mr. Chairman, I believe the Chair knows I am committed to the principle of economy in government. Taxpayers should not have their hard-earned dollars wasted. Many efforts to restrain costs in government are worthwhile, but it seems to me that those efforts which serve no useful purpose should be stopped.

I would like to set out very briefly what are, to me, four compelling reasons to repeal the Vinson-Trammell Act:

First is that the Vinson-Trammell Act was written for another age. Just take your mind back to the Washington Naval Treaty of 1922 and the London Naval Treaty of 1930; that is way, way back in history in terms of modern defense.

Senator MORGAN. You will have to tell me about those. I was not around.

Senator MATHIAS. I know the chairman is considerably younger than I am, but when you get back to the Washington Naval Treaty of 1922, even I have problems; but that underscores, really, what we are dealing with. We are dealing with an antique provision of law, that the memory of man runneth not that far; nobody really remembers, but that is what the Vinson-Trammell Act was all about. The act and the profit limitation provisions in the act were intended for emergency procurement conditions as the Government rushed to sign contracts and to begin production during the Depression. It really does not address the vastly different procurement environment and economic circumstances today.

Of course, it is interesting that the act, because it is addressed to these two naval conferences, covers only naval vessels and aircraft; it overlooks the expensive items of hardware that are in procurement budgets today—missiles, spacecraft, satellites, computers, sophisticated electronics—and it does not cover the nonmanufacturing contracts such as testing, maintenance, repair, modification, and modernization.

So, it is very clear that it is a measure which was not designed to address military procurement practices in the 1980's.

Second, I am glad to say that the Government uses stronger and more sophisticated procedures to negotiate contracts and to monitor military procurement today than it did when this act was adopted. The best place to prevent excessive profits in defense contracting is in the negotiation of contracts and the oversight of contracts but not going back to try to rewrite the contract at a later date.

The Defense Department negotiators today have all kinds of tools they didn't have when the act was written. They have the Truth in Negotiations Act, the Cost Accounting Standards Act, the Defense Contract Auditing Agency. So, they are in a position to—and I believe that they do—drive very hard bargains in the first place.

Then there are Defense Department administrators to monitor the fulfillment of contracts through an elaborate system of production controls and performance measurements.

So it is really difficult to understand why the Federal Government should ever enter or experience an excessive profits contract, because the responsibility for effective procurement lies with those who negotiate and monitor these contracts.

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The Defense Department today has the tools and the authority and I think they should be using them. If they aren't, then we need new people in the Defense Department.

Third, the definition of "profit" in the Vinson-Trammell Act is very rigid and very unfair and can result actually in higher costs to the taxpayer, rather than savings to the taxpayer. The use of a single, inflexible measure—profit as a percent of sales price—really does not provide an adequate picture of the financial operations of a business. So many things occur in today's chaotic economic climate. We are dealing with capital investment, with asset turnover, with business taxes, interest rates—all sorts of things which can have a substantial impact on profit.

Under the Vinson-Trammell measure of profit, a contractor's strategy for maximizing the allowable profit would be to increase costs and sales price. There would be no incentive to reduce costs or to improve productivity by investing in more efficient equipment. As a result, the Government may pay a higher price instead of a lower price.

It seems to me that profit policies ought to provide incentives for a contractor to increase capital investment.

Fourth and finally, Mr. Chairman, military weapons today are very expensive and they are expensive for reasons that are unrelated to profits and for reasons that the Vinson-Trammell Act simply does not address. That is no criticism of the authors of the act, because it deals with situations that didn't exist when Carl Vinson was so active and was such a strong leader in the Defense Establishment.

But a more current view of the scene is provided by the General Accounting Office report of November 8, 1979, entitled, "Impediments to Reducing the Costs of Weapon Systems." It identifies major factors leading to increased weapons systems costs.

The GAO, according to the report, "believes the major effects on costs have resulted from: attempts to deploy systems with new technology and high performance, low rates of production due to budget constraints and desires to maintain active production bases as long as possible, absence of price competition between contractors, lack of real motivation on the part of contractors to reduce costs, the impact of socioeconomic programs, Government controls and red tape, and a nationwide problem of reduced research and development expenditures and lessening productivity."

That is what GAO says is driving up the costs of these systems.

It is interesting that not anywhere in that report is there any allegation that excessive profit is driving up the price.

So, on the basis of the most recent sophisticated look at the problem, the Vinson-Trammell Act would not seem to be even addressing the real problem.

I know, Mr. Chairman, because I know from your own record, that we share concern over the ever-rising costs of weapon systems. There is no question that the costs of major weapon systems have increased dramatically since the end of World War II, even if you discount the effect of inflation.

I had a long meeting on Friday afternoon with Admiral Holcomb, Admiral Carroll, and Admiral Shapiro of the Navy. We were discussing that even with constant dollars, the price of weapon systems

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goes up. Budget constraints require that we control these costs as much as possible, but the Vinson-Trammell Act really adds nothing to the cost-reduction efforts; and I believe, sir, that it should be repealed.

Senator MORGAN. Thank you, Senator, for a very thoughtful statement.

You mentioned that it removes, in some cases, incentives to keep costs down. I can conceive of some instances where it actually would not only eliminate incentives for keeping costs down, but might also very well encourage it. I suspect there are some areas where 10 percent profit in building a ship over all would be a fairly good profit.

Senator MATHIAS. If you are talking about a nuclear carrier, anybody who can settle for 10 percent would do pretty well. That kind of rigid cost factor really isn't practical today.

I served for many years with Carl Vinson in the House and if he was anything, he was a pragmatist; his great opening line for a Defense Department witness was to say, "Now, Admiral, take off your muzzle," and he wanted the facts; he really wanted to get at the facts. I happen to believe that if Carl Vinson were in Congress today, he would have an active interest in seeing a pragmatic decision made on this bill and would recognize that the times have changed.

Senator MORGAN. You know, some of the staff and I were talking earlier that there are other areas in which technology is changing so fast and so quickly that if you limited a manufacturer to 10 percent profit, he simply could not retool and redesign as fast as he has to, to meet the needed changes in technology.

There are some very real problems in this. There is some reluctance on the part of some, as Senator Pell mentioned before you came in, to removing all profit restraints, and certainly there is a question of public policy and whether or not we can do it.

I think you have certainly pointed out some areas that indicate difficulty.

As I said earlier while you were here, we are just opening the doors today; so we would like to work with you and we will try to keep you informed as we begin to develop.

Senator MATHIAS. Mr. Chairman, I have been interested in this whole subject since we fought the battles in the Appropriations Committee on the Renegotiation Board. I think I made it clear in that context, as I make it clear here, I am not interested in seeing anybody make an unearned profit or unjust enrichment. I think the taxpayers' dollars have to be preserved, but some of what looks like simple formulas for preventing excess profits can end up as being inhibitions against the efficient operation of government.

There is no substitute for commonsense; there is no substitute for sound administrative ability; there is no way we can take second-rate administrators and give them some legal formula and have them come up with the right results. We have to have vigorous and strong administration. I think we can come out ahead.

These simple solutions remind me of my fellow Marylander, H. L. Mencken, who used to say, for every problem there is a solution which is simple and easy and wrong, and the Vinson-Trammell Act is one of them.

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Senator MORGAN. During the discussion of renegotiation in Appropriations, were you aware of the fact that if renegotiation was allowed to die that this act would then come back in place?

Senator MATHIAS. Yes; we were aware of it. We felt that we had to take things a step at a time and that commonsense would prevail in this case. We felt that when we really had to look this straight in the eye, we would take the step contemplated by the bill now before your subcommittee. We didn't feel that there was a reason for shrinking or holding back from doing the sensible thing and the right thing in connection with renegotations.

Senator MORGAN. I think we were probably right. If we got involved with all of them at one time, we probably would still be left with a cumbersome system.

Thank you a lot.

Senator MATHIAS. Thank you, Mr. Chairman.

Senator MORGAN. Senator Lugar, I notice that you have come in. You are cosponsor of a bill which simply eliminates Vinson-Trammell.

We welcome you. We have heard from Senator Pell, who introduced the bill raising the minimum limits from $10,000 to $1 million. In his comments he spoke of the difficulties in administering Vinson-Trammell. He also spoke of the desirability of perhaps keeping some kind of limitation in place.

Then we heard from Congressman Patterson, and you are familiar with his bill. You heard Senator Mathias. Now we have Senator Cranston, your cosponsor.

So, which one of you desires to go first?

STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM THE STATE OF INDIANA

Senator LUGAR. Mr. Chairman, I welcome this opportunity to appear today with my distinguished colleague, Senator Alan Cranston, to urge the Subcommittee on Procurement Policy and Reprograming to recommend immediate and full repeal of the Vinson-Trammell Act.

Senator Cranston and I have introduced S. 1687 to repeal this relic of the 1930's. Enactment of this legislation or similar legislation is essential if the Congress is to avoid reimposing unnecessary and confusing reporting burdens on defense contractors and subcontractors similar to those which only recently were eliminated by the expiration of the Renegotiation Act and the demise of its implementing agency, the Renegotiation Board.

As the committee knows, the expiration of the Renegotiation Act on September 30, 1976, automatically reinstated the Vinson-Trammell Act of 1934 which had been suspended by the Renegotiation Act of 1951 and its 13 temporary extensions.

The 95th Congress expressly terminated the activities of the Renegotiation Board by providing appropriations only for 6 months, in addition to severance pay for the Board's employees in fiscal year 1979.

Senator MORGAN. Let me interrupt you just a minute, while you are on this point.

The act was enacted in 1934; the Renegotiation Act was adopted in 1951, which suspended it. Now, what happened in that interval?

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I have some recollection that it actually only applied maybe a couple of years, 1946, 1947, and 1948.

Was there some act or powers bill that might have suspended it earlier?

Senator LUGAR. I am not aware of this, Mr. Chairman. I would have to check the history of it.

Senator MORGAN. We can look into it. It is more a matter of curiosity, but I would like to know if it did work, say, from 1934 to 1951 and if it did, how did it work and so on.

I am sorry, I did not mean to interrupt you.

Senator LUGAR. The Vinson-Trammell Act was enacted in 1934 to place a ceiling of 10-percent profits on shipbuilding contracts and was amended in 1939 to include a 12-percent ceiling on aircraft construction.

These profit limitations were enacted as part of President Roosevelt's efforts to modernize our Nation's Air Force and Navy and occurred at a time when contracting procedures were seriously unsophisticated. To allow Vinson-Trammell to remain on the statute books would contradict the fundamental rationale underlying the 95th Congress' explicit decision to allow the Renegotiation Board to go out of business.

During the 95th Congress, the Senate Banking, Housing, and Urban Affairs Committee held extensive hearings on legislation to extend and expand the Renegotiation Act, the authority for which had been allowed to expire during the 94th Congress. Testimony by the Government and private sector witnesses presented clear and convincing evidence that the Renegotiation Board was a superfluous agency which imposed expensive reporting requirements on defense contractors and, in the final analysis, was counterproductive to an efficient defense production industry.

As a result of the hearings and deliberations, the Senate Banking Committee reported S. 2791, the Renegotiation Abeyance Act. S. 2791 "mothballed" the act and the Board which administered it, while allowing it to conclude all business pending before it on the act's expiration date of September 30, 1976.

After concluding all business and allowing a reasonable period for court appeal, S. 2791 would have dismantled the Board and kept the act in abeyance until such time as the President determined, during a national emergency, that such provision would be in the best interest of the United States.

Mr. Chairman, this subcommittee would not be conducting these hearings had S. 2791 and companion legislation in the House been enacted. Unfortunately, a time agreement could not be reached on S. 2791 and, therefore, the Renegotiation Board's final demise resulted from a cutoff of appropriations. The Vinson-Trammell Act remains as its legacy.

The IRS and the Department of Defense have joint responsibility for implementing the Vinson-Trammell Act. Both IRS and DOD recently have published proposed implementing regulations and forms in the Federal Register. The promulgation of final regulations and forms has not yet occurred but could at any time.

The paperwork burden of the act and its implementing regulations and forms will be considerable, possibly more so than under the

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Renegotiation Act. Contractors and subcontractors will be required to file reports with the DOD for each contract subject to the act. Further annual reports aggregating the information sent to DOD will have to be filed with IRS.

The regulations apply both to defense contracts and subcontracts over $10,000 for equipment or supplies to be included in a complete new ship or aircraft. DOD estimates that roughly 500,000 annual filings from 10,000 separate contracts will be required, at an annual cost to contractors of $80 million.

DOD admits that this estimate is conservative and could be off by as much as a factor of three. To this estimate must be added the cost of filing reports with the IRS, the cost of audit and the cost to the Government of maintaining the information.

Costs and reporting burdens aside, the profit limitations of Vinson-Trammell will have the same adverse impact on defense production as the Renegotiation Act did.

More specifically, with its focus on profits rather than costs, it would be counterproductive to the goal of keeping defense costs down. Because of the uncertainty it would create, it would aggravate the serious problem of capital shortfall in the defense industry. It would discourage contractors from seeking improved productivity or other cost-reducing features. It would keep new or additional contractors away from the market, thus stifling competition and most probably increasing costs to the Government.

Mr. Chairman, the need to repeal the Vinson-Trammell Act is apparent and compelling. I join Senator Cranston in urging this subcommittee and the full Armed Services Committee to report legislation promptly to repeal it.

Thank you.

Senator MORGAN. Thank you, Senator Lugar.

Let me see if I have it straight. You say that the bill that we reported out of the Banking Committee, S. 2791, simply mothballed the Renegotiation Act?

Senator LUGAR. Yes, sir.

Senator MORGAN. That had it passed, we would not be here today?

Senator LUGAR. Yes, because it would have superseded Vinson-Trammell.

Senator MORGAN. When we let it die by failure to appropriate money, did we, in effect, repeal the act?

Senator LUGAR. In effect, I suppose we simply let the whole situation expire; that is the Board and perhaps the act, too. That clearly is the assumption under which all parties are going as they promulgate the regulations.

Senator MORGAN. It is a rather technical question, but I think you are right, that it is the assumption that we have all been going under. We may have a witness later on who can clear it up. It really is a technical question.

What is your understanding of the handling of the Vinson-Trammell Act during the lengthy debates that we had over the Renegotiation Board, was it discussed at all?

Senator LUGAR. I am not certain that it was discussed in the Banking Committee, as I recall. I think it was well known that it was lurking in the background.

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I heard Senator Mathias' testimony preceding mine. My understanding is identical with his, that the problem of getting rid of the Renegotiation Board was a considerable challenge. To have tried to repeal the Board and Vinson-Trammell at the same time, seemed to be an insuperable situation.

I think all of us who have been involved in this quest were aware that Vinson-Trammell was there, and I suppose that the need for this type of hearing and direct action to clear the books would be required.

Senator MORGAN. Let me ask one other question: In your view, how can the taxpayers be protected from the occasional case of running large unanticipated profits on defense contracts if we repeal this act completely, having already abolished, in effect, the Renegotiation Board? Occasionally you have an outlandish case. What can we do?

Senator LUGAR. I think it would be appropriate for this subcommittee and for the full Armed Services Committee to consider that issue per se. It just seems to me that we have a very difficult problem in Government, generally, of ever getting rid of any agency or any outmoded law; and to couple consideration of what would be an appropriate set of protections with the repeal of this is to invite, I am afraid, a difficulty on both fronts.

At least in my experience, and this has been more limited, I suspect, that Senator Cranston's and your own, as I have already testified, we made a straightforward attempt in the Banking Committee to leave in mothballs the situation under the Renegotiation Act. It was only because of the intransigence, literally, of those who were trying at all odds to keep it on the books, that finally we had to go through the Appropriations Committee route and starvation by money that led us into this predicament now of trying to repeal Vinson-Trammell.

In hope in a straightforward way we can clean up Vinson-Trammell, and that is why Senator Cranston and I have come with a clean bill of repeal here, in the interest of taxpayers, of our obligation as Senators, and pass a straightforward protection uncoupled with this repeal.

Senator MORGAN. Thank you, Senator Lugar.

Senator Cranston, would you care to add a statement to what your colleague has already said?

STATEMENT OF HON. ALAN CRANSTON, A U.S. SENATOR FROM THE STATE OF CALIFORNIA

Senator CRANSTON. Yes; I agree with his response to your last question. I think the way to go is to repeal Vinson-Trammell, which has a sort of scattershot approach. A rival approach would zero in on a specific problem of a few aberrations. Where there are a few unexpected profits made, that would be a wiser way to go.

I am delighted to have this opportunity to appear with Senator Lugar to urge repeal of Vinson-Trammell in accordance with the bill that he and I have introduced.

I think there is general agreement that the Vinson-Trammell Act is out of date and poorly suited for today's defense procurement and contracting purposes. Defense procurement has come a long way since the 1930's when the Vinson-Trammell Act was last seriously considered by Congress.

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Since that time, particularly in the 1970's, there has been a major reworking of defense contracting laws and procedures. We have enacted the Truth in Negotiations Act, a powerful sanction which promotes sound and honest bargaining between the Government and defense contractors.

The Cost Accounting Standards Board has accomplished pioneering work in the establishment of common standards of cost accounting so that the Government can better determine what costs it actually is paying for in a negotiated contract.

Other reforms have been accomplished.

Today's procurement officials and contracting officers are highly trained, competent individuals. Contracting officers have power to conduct onsite audits at any time during the performance of a contract and to challenge costs. Upon renewal of contracts, full opportunity exists for the Government to review the performance of the contractor and to insist upon a better price if the contracting personnel thinks the Government did not receive the best possible bargain.

Vinson-Trammell, like the now defunct Renegotiation Act, deals with an after-the-fact situation. Under Vinson-Trammell, the IRS adds up a contractor's wins and losses for the tax year and then taxes the overage, in addition to his regular taxes.

The procurement agency is not affected. From the agency's point of view, it could not care less whether the contractor did or did not exceed the profit limitations prescribed by the Vinson-Trammell Act. In fact, the Vinson-Trammell Act is an open invitation to inefficient contract negotiations and wasteful performance.

The Vinson-Trammell Act does nothing to encourage the Government to seek the best bargain possible for the taxpayer. In fact, it encourages sloppy bargaining, just as did the old Renegotiation Act.

Perhaps of greater concern are the incentives for inefficiency and wastefulness built into the Vinson-Trammell Act. The encouragement to waste is substantial and is very simple: Since costs can always be charged against the profits of a contract, thereby bringing profits down, the act encourages the contractor to charge as much as he can against costs under the contract.

Conversely, the act does nothing to encourage the contractor to reduce costs and to eliminate waste. I continue to feel as I did when I advocated successfully the demise of the Renegotiation Board, that profits are less of a problem in defense contracting than overruns and lack of efficiency. These are very real and extremely costly problems.

The increased defense budget makes it more important than ever that the Government tighten its controls over cost overruns and improve its military planning.

I strongly support an increased defense budget in this time of international crisis, but I am also deeply concerned about inflation which constitutes a domestic crisis and the effect of unnecessary Government spending on that crisis.

Profits are, under our system, by far the best incentive for efficiency and cost reduction. I can think of nothing more counterproductive than to revive an unwise statute with nothing more to commend it than "cosmetic or psychological appeal."

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I know you are concerned that some contractors may engage in price gouging, and you have responsibility as chairman of this subcommittee to consider ways of dealing with the problem as you see it.

I strongly suggest to the subcommittee that it follow the advice given to the Banking Committee by former Deputy Secretary of Defense David Packard, who told the committee that if we felt there was a problem of price gouging, to use a rifle, not an across-the-board shotgun approach as embodied in the Renegotiation Act and the Vinson-Trammell Act.

Frankly, I feel the solution rests in the contracting process itself. Careful Government negotiations of the original defense contract and subsequent strong management of the contract performance by onsite Government officials should be enough to prevent price gouging.

The job can and should be done by the defense agencies. To shift the job to IRS or to establish a new profit-regulating agency simply relieves the contracting agency of the responsibility it, in fact, does have and should have of protecting the taxpayer.

I ask the subcommittee not to delay repealing the Vinson-Trammell Act while experts spend time devising a solution to a problem which David Packard, a man who should know, suggests has yet to be defined objectively and accurately.

I do not think simply raising the exemption threshold in the Vinson-Trammell Act is an answer. I also suggest that proposals based on the simplistic concept of determining a profit as an amount in excess of costs raises far more questions than it answers.

Finally, all proposals for regulating defense contract profits ignore the fact that profits constitute taxable income. The Government gets its share—up to 43 percent—and the Government gets a second crack when the profits are paid as dividends to private shareholders.

Then there are the capital gains taxes on the value of the stock when sold; profits obviously help here, and, ultimately, estate taxes will be paid on the value of the stock.

The Government also taxes the employees on their salaries and wages.

I might add that price/earnings ratios of stock, helped by profits, reduce the cost of capital to defense companies.

This redounds to the benefit of the Government directly, since cost of capital is an item of cost includible in a cost-plus negotiated contract. This cost, by the way, is identified by an appropriate cost accounting standard promulgated by the Cost Accounting Standards Board.

Senator CRANSTON. My point, Mr. Chairman, is that profits must be seen in the total context. The Vinson-Trammell Act approach completely ignores the real world of defense contract business; it should be repealed.

Senator MORGAN. Thank you.

Why was this thing put into IRS for enforcement?

Senator CRANSTON. Because that was known as an excess profits tax. The simple and direct approach is straight repeal.

Senator MORGAN. It was actually put there because it was collection of a tax?

Senator CRANSTON. Yes.

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Senator MORGAN. Thank you, gentlemen. I believe you have given us a good insight in your views.

As I said to Senator Lugar and others earlier, we are beginning hearings today; we are just getting into the opening round. We will probably be back sitting down and working with you across the stage.

Senator LUGAR. I would like to ask unanimous consent that a resolution forwarded to me by the American Bar Association with regard to the Vinson-Trammell Act be made part of the record.

Senator MORGAN. We will be glad to receive it for the record.

I might mention, I am a member of the ABA, so I can talk about it if I want to. Thank you very much.

[The resolution follows:]

Be it resolved that the American Bar Association favors the elimination of the profit limitation provisions of the Vinson-Trammell Act, and does not favor the adoption of any similar authority for profit limitation during peace time.

Senator MORGAN. We are going to hear next from Mr. Dale W. Church, the Deputy Under Secretary of Defense for Acquisition Policy.

Mr. Church, we welcome you to the committee. Thank you for coming. We will be glad to hear from you.

STATEMENT OF DALE W. CHURCH, DEPUTY UNDER SECRETARY OF DEFENSE FOR ACQUISITION POLICY; ACCOMPANIED BY MAJ. GRADY JACOBS, STAFF MEMBER

Mr. CHURCH. Thank you, Mr. Chairman. I am accompanied by Maj. Grady Jacobs, who is my staff expert in the area of profit limitation, Vinson-Trammell, renegotiation and otherwise. He will be available also to answer questions of a technical nature. He pointed out to me something of interest based on your comments about the history of Vinson-Trammell.

We have in the audience today Mr. Alexander Kirk, who was on the Renegotiation Board back in World War II days. If we need him, we have an expert that goes back this far.

To try to answer your earlier question as to when the act did or did not apply, it was only applied for 5 years prior to 1976. As best we can recall, it was in the period from the time the act was passed until 1939. It was about 1940 when the first Renegotiation Board was established, and these Boards were fairly continuous from that time, only there were a series of various enabling statutes for them.

I think it was in 1951 when reorganization changed from being administered by the Defense Department, or probably then the Department of War, over to an independent Board. It was 1951 that really saw the establishment of the first independent Board outside the Defense Department, but there was during World War II a continuous Board under the Defense Department or Department of War, which was looking at excess or war profiteering in those times.

Senator MORGAN. No doubt suspended or superseded Vinson-Trammell during the war period?

Mr. CHURCH. Exactly.

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Senator MORGAN. It is likely that it would have been, but I didn't know what it was.

Mr. CHURCH. The Department of Defense has certain obligations under the Vinson-Trammell Act, basically to include its requirements in all our contracts, to prescribe a reporting form to reach agreement with the Treasury on the method of computing excess profits, which we are still in the process of doing, to designate certain exemptions and to audit and inspect the books of the contractor or subcontractor for covered supplies.

Right now, we in the DOD are simply stuck with the Vinson-Trammell Act. It is on the books; it is the law. We have no choice but to proceed with its implementation. That we have been moving with all due deliberate speed is probably the best way to characterize it. We have been moving rather slowly in trying to look at the many facets of it and trying to come up with a regulation or procedure which is the least onerous on our contractors.

However, the way we look at it, even the least onerous regulation will have a devastating impact on our defense industrial base.

As was pointed out here earlier, it certainly is going to affect many small contractors, as well as large contractors. Some industry estimates are that up to 40 percent of our current suppliers would simply stop accepting orders; 20 percent would look at it on a case-by-case basis to see what their profit margins are on that particular product, in order to determine whether or not they want to respond to our requirements.

It is a vexing problem for prime contractors, but even more so as we get below the prime level. It is an enormously costly effort of trying to keep records for each set of supplies or goods which a contractor is manufacturing. It is estimated, as was mentioned earlier, that it may be up to $80 million, maybe three times that amount, in paper work and additional costs throughout the defense contractor community.

Obviously, the $10,000 threshold in today's world is a very small sum and would cover almost everything we do. It does not seem to make a lot of sense to attack only airplanes and ships if you are going to talk about profit limitation. I think it was pointed out well that some of our major and most expensive systems are missiles, electronics, spacecraft, tanks, and the like, which are not covered by profit limitation.

In looking at the overall need for a profit limitation beyond that of the outright repeal of Vinson-Trammell, because there has been a discussion of that from some of the witnesses, and I think it needs to be looked at, we must ask what follows, if anything, Vinson-Trammell?

We in the DOD believe there is a case for a reasonable and workable profit limitation statute as a matter of public policy. When we say "reasonable and workable" we mean one which really attacks the majority of the dollars, but is done in a manner that is the most cost effective. By that, I mean that any recoupment would in fact be for real windfall, unearned profits and still would require the minimal administrative effort.

It was testified here earlier today that we might need 13 people. I don't know where that figure came from. The fact is I would envision

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a reasonable, workable profit limitation as being one that we would need literally no new people to administer it; one that we could administer with our present staff.

We need only look at a few peculiar situations and this could be accomplished by self-certification by contractors. We do many other areas of our business under self-certification. I don't see why we could not here, when at the conclusion of his work, when he has determined that he has a profit in excess of whatever the prescribed amount is, then he could say that "I do" or "I do not." If he does not, then it need not go any further. He does not even have to report on it.

If he does exceed the limitation, then he needs to so state. Then we will look to see what are the available offsets, such as performance incentives or other kinds of incentives on the contract. I believe the affected contractors would be only a handful even considering those that might qualify under the Patterson bill.

I think Congressman Patterson is talking in terms of 800 prime contracts that might exceed $5 million in the sole-source environment, and I think it would be only a handful of those that would qualify for certification of profit in excess of the amount he is talking about—15 percent.

There are certain portions of negotiation of a contract where the current rules are not totally applicable or do not cover all situations. Subjective contingencies are included in a contractor's price. Public Law 87–653 prescribes the submission of certain data which goes to the facts; it has to be current, complete and accurate.

But not all determinations and negotiation of contract prices can be made on facts. There have to be a number of subjective determinations; then we get to the bottom line, the markup that is added onto the cost. These subjective determinations are not covered by Public Law 87–653 or the Cost Accounting Standards. The contractor, if he is negotiating a cost reimbursible type contract, including cost reimbursement incentive contracts, is limited to a 15-percent final profit and markup; but in other contracts the markup can be whatever he can negotiate.

There is no limitation of markup on a fixed-price contract. There is no audit for fixed-price contracts after the fact. Once a fixed-price contract has been negotiated and settled, only an examination of records clause would provide for audit. So, indeed, he can attempt to increase his profit through these negotiations. When he is in a sole-source environment, the Government does not have the leverage in all cases, particularly in the Defense Department, where we are working against threats outside the United States, where national security is literally at stake, and where we must move as rapidly as possible to obtain needed supplies and equipment.

I know the chairman and many on the Armed Services Committee are very concerned about the speed with which we need to get an initial operational capability of some of these systems. The negotiating process cannot be stalled for long periods; it must move forward.

Yet, also, the chairman is aware that in many circumstances there is only one contractor in the United States, particularly at the prime level, who is capable of building a major weapon system. Therefore, we think that a reasonable kind of profit limitation would provide

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the kind of overall public measure of assurance that when we do run into a windfall profit situation, that is where the contractor literally has negotiated a situation that inures to his benefit without his having earned it or without becoming more efficient these profits will be recouped. There are only a few situations in which this would occur. We think that for the most part our negotiators do an outstanding job. We do not think our contractors are unfair in trying to negotiate unreasonable markup situations, because it is the final profit that a contractor earns which makes sense to him.

The markup is only a going-in position of where he has a crack at that profit; it is really after the work is all said and done that we find out what the real profit is.

We would like to see a profit limitation situation that would set a percentage of sales which that final number could not exceed, and not seek to limit that which is going in, although obviously it would influence that markup.

We think that the assertion that profit limitation should only apply in times of war or declaration of war by the Congress is inadequate. With the threats we face today and the Soviet challenges around the world, one can argue that the buildup and requirement to catch up is such that we are indeed in a situation now where we must move forward as if we were almost in a war scenario.

There is a very fine line between conditions that exist outside of a declared war and those that are within a declared war with respect to defense contracts.

That concludes summarizing my prepared statement. We certainly are prepared to answer any questions that you might have with respect to our views on profit limitation. Thank you.

[The prepared statement follows:]

THE DEPARTMENT OF DEFENSE'S PREPARED STATEMENT ON THE VINSON-TRAMMELL ACT AND THE NEED FOR PROFIT LIMITATION LEGISLATION BY MR. DALE W. CHURCH, DEPUTY UNDER SECRETARY OF DEFENSE FOR ACQUISITION POLICY

Mr. Chairman and members of the committee, I am pleased to present to you today the views of the Department of Defense concerning the Vinson-Trammell Act and the need for profit limitation legislation.

BACKGROUND OF THE VINSON-TRAMMELL ACT

The Vinson-Trammell Naval Parity Act of 1934 (Public Law 73-135, 48 Stat. 505, as amended (1934)) limits profits on contracts and subcontracts for complete Naval vessels (and parts thereof) to 10 percent, and for complete military aircraft (and parts thereof) to 12 percent, of final contract prices. The requirements of the act were suspended by the Renegotiation Act of 1942 (54 Stat. 245 (1942)) and 1951 (50 U.S.C. App. §§ 1211-33). With the September 30, 1976, expiration, without renewal, of the Renegotiation Act of 1951, the requirements of Vinson-Trammell again became operative.

While the act is administered by the Department of the Treasury, the Department of Defense has the following responsibilities and authorities:

(1) To include the agreements required by the act in all contracts for covered supplies.

(2) To prescribe the form of a report to be made under oath to the Department of Defense by contractors and subcontractors.

(3) To reach agreement with the Secretary of the Treasury on the method of computing excess profits.

(4) To designate for exemption, certain contracts or subcontracts for scientific equipment for communications, target detection, navigation, or fire control.

(5) To audit and inspect the books and manufacturing spaces of the plant of a contractor or subcontractor for covered supplies.

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On October 26, 1979, the Department of the Treasury published proposed rules for implementing the act. This was necessary since their regulations were last issued in 1939 and were seriously outdated. The Department of Defense published proposed rules and a reporting form on December 26, 1979. At the same time we sought comments on two matters where we disagree with the rules proposed by the Department of the Treasury.

The Administration and the Department of Defense firmly believe that the Vinson-Trammell Act, in its present form, is an outdated statute which should not be implemented. Implementation of the act would be costly, imprudent, and would seriously affect the industrial base necessary for the defense of this nation. Unfortunately, the Departments of Treasury and Defense have no choice at this point other than to proceed with its implementation. We hope that this antiquated and flawed act can be replaced with a profit limitation statute which is reasonable, workable, cost effective, and meets the public policy need for profit limitation on defense contracts.

PROBLEMS WITH THE VINSON-TRAMMELL ACT

There are a number of serious problems associated with implementation of the Vinson-Trammell Act. While most of these are administrative, we believe implementing the act would have a devastating impact on the industrial base. While no precise figures are available, we understand that surveys conducted by industry associations indicate that as many as 40 percent of the smaller subcontractors who have business covered by the act would simply stop accepting orders subject to record keeping and profit limitation required by the act. Another 20 percent would look at each order on a case-by-case basis and only accept orders for items with profit margins that are less than the limits imposed by the act. Many of these firms are in high technology areas and supply items that are critical for our aircraft and ship systems.

The most significant administrative problem is determining which items in contracts and subcontracts are covered by the act. While this is not too difficult at the prime contract level, it is a most vexing problem with first and lower tier subcontracts. These subcontracts may include quantities of material or supplies destined for both end items covered by the act and for material inventories or stocks of spare parts, which would not be covered by the act. This wou'd result in only a portion of the subcontract being subject to the profit limitation, and create an enormous and costly record keeping and accounting problem for these suppliers.

Due to inflation, the $10,000 threshold for application of profit limitation has resulted in an expansion of contract and subcontract coverage far beyond what was envisioned in 1934. A $10,000 contract in 1934 is roughly equivalent to a $50,000 contract today. We estimate that this factor alone will result in a fourfold increase in the relative number of contracts and subcontracts that would be covered, and the number of reports that wou'd be submitted to both the Departments of the Treasury and Defense.

The limited applicability of the act to only naval vessels and military aircraft leaves a whole array of defense equipment outside the scope of any profit limitation legislation. We do not believe it makes sense to apply a profit limitation to military aircraft and naval vessels and at the same time have no limitation on contracts for missiles, electronic systems, spacecraft, tanks, military vehicles, munitions, and other items essential for defense.

THE NEED FOR PROFIT LIMITATION LEGISLATION

While we believe the Vinson-Trammell Act in its present form is outdated, and will be impossible to effectively implement, we also believe that there is a need for a reasonable and workable profit limitation statute as a matter of public policy.

There are certain market environments where profit limitation is not required, or desirable as a matter of public or economic policy; these include:

Contracts awarded through formal advertising;

Negotiated contracts, where: there is adequate price competition; or prices are based on established catalog or market prices of commercial items sold in substantial quantities to the general public; or prices are set by law or regulation.

In these markets, either competition will assure an adequate degree of reasonableness in estimating and pricing, or there is a going market price established

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independently of the Government; or prices reflect the public interest. In a competitive market, profits should be considered as the reward for economical and efficient operations and should not be subject to any legislative limitations.

On the other hand, there is a market environment where profit limitation is needed. A large portion of the total dollar value of defense contracts are negotiated in this market. I refer to the market where contracts are negotiated with a sole source. Here, there is no requirement or incentive for a contractor to exercise the same degree of reasonableness in estimating that would be applied in a competitive market environment. Firms will seek to minimize their business risks by assuring that prices cover all possible contingencies. We could be placed in a position of having to accept unreasonable contingencies because military requirements may not provide adequate time to reach a satisfactory agreement on price. To the extent that contingencies are included in a contract price, and do not materialize, excessive profits would accrue to the contractor. These profits would not be the result of economy or efficiency but rather the result of negotiating from a position of superior strength. We believe it is manifestly in the public interest that such unearned profits be recouped.

WHY EXISTING LEGISLATION IS NO SUBSTITUTE FOR A PROFIT LIMITATION STATUTE

In Government contracting, price negotiation is generally conducted by reaching an agreement on price, based on a set of factual data, and the judgments and assumptions used in projecting from these facts to an agreed to price. The process is shaped, but is not limited by cost accounting standards and other accounting rules. Department of Defense contract cost principles will limit recognition of certain elements of cost, but not the total price.

There is a need to clearly distinguish between factual data and judgments when considering the requirements of existing legislation. Factual data includes such things as historical material costs, labor hours, labor rates, and overhead rates. These are a matter of record and are therefore auditable and verifiable. Public Law 87–653, the Truth-In-Negotiation Act, requires that factual data submitted in connection with the negotiation of certain noncompetitive defense contracts be complete, current, and accurate. The Government has the right to obtain a price reduction if it relies on incomplete, noncurrent, or inaccurate factual data, and this results in a higher price.

This law does not apply to the many judgments that are made in projecting from factual data in order to arrive at estimates of future contract costs. These judgments include such things as:

Assumptions regarding the behavior of future labor and material price levels, or inflation rates;

Business volume assumptions which, in turn, affect estimates overhead costs;

Projected scrap and rework factors;

Anticipated testing or product failures.

These judgments are kept reasonable, or even optimistic, by competitive pressures. On the other hand, it is human nature to be conservative, or pessimistic, in estimating when a contract is assured. The result of unconstrained conservative estimates can be unanticipated, or windfall profits. There is no provision in any existing law which provides a means for the Government to recover these profits.

My statement should not be taken to infer, however, that there are a great deal of windfall profits currently accruing to contractors. The evidence would seem to point to the fact that all too often contracts are completed with the contractor earning less profit than was anticipated at the time it was negotiated. We believe the Department of Defense, on balance, does an exceptionally good job in negotiating noncompetitive contracts, and this is borne out by a number of reviews conducted by the General Accounting Office. This does not obviate the need for a statutory profit limitation, however. We believe such an act would be in the public interest even if it were seldom invoked to recoup excessive profits. It would provide the public a measure of assurance that our contracting system is working well.

DESIRABLE CHARACTERISTICS OF PROFIT LIMITATION LEGISLATION

Based on our observations on implementation of the Renegotiation Act of 1951, and experiences in attempting to implement the Vinson-Trammell Act, we believe there are certain essential characteristics that profit limitation legislation should embody. These are:

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(1) There should be a concise, objective definition of what constitutes excessive profits, and how profits are to be calculated.

(2) Efficiency and economy should not be penalized. This would involve exempting amounts that can be objectively determined as incentives paid for achieving economies or efficiency in contract performance, such as amounts earned under performance incentive, award fees, or value engineering incentive contract provisions.

(3) Profit limitation should apply to all commodities at all times, not just in times of war or national emergency. History has shown that the application of these labels does not always describe the true state of world or national affairs.

(4) Only large, noncompetitive Department of Defense contracts should be made subject to profit limitation. We estimate that the following dollar thresholds would result in covering the indicated number of new prime contracts and percentage of the total dollar value of contracts awarded each year by the Department of Defense:

Contract value threshold	Contracts covered	Percentage of contract awards covered
$10,000,000	430	50
$5,000,000	850	57
$2,000,000	2,000	67
$1,000,000	3,300	72
$500,000	6,100	78

In our view, a $5 million threshold for profit limitation would strike a proper balance between the administrative cost of record keeping, audits, and other functions necessary for administration, and the dollar value of contracts covered in relation to total contract awards.

(5) Administration should be made as simple and as economical as possible, and every effort should be made to eliminate subjective judgments in determining whether excessive profits exist and are to be recouped. If this is done, the opportunity for disputes and litigation will be minimized, and it would not matter whether the Department of Defense, or an independent agency administers the statute.

(6) The upper limit set on profits should be consistent with existing laws, regulations and policies; should make good economic sense; and should be sufficiently high so as to allow for a spread of realized profits consistent with rates of profit currently anticipated in contract negotiations.

That concludes my prepared statement. I will be happy to answer any questions you may have on this subject.

Senator MORGAN. Thank you, Mr. Church.

Let me ask you, in the beginning, if you can repeat for the subcommittee, the status of DOD's proposed rules?

Mr. CHURCH. We held a hearing on February 19, which Major Jacobs chaired. There was a good turnout of both industry and other commentators on the subject. We received a lot of good comments. We are having a record prepared which we will provide this subcommittee as soon as it is available.

It is our intention to proceed with additional hearings, because of the turnout at the first one. We will hold these in at least two or three other areas of the country in the next month, with the goal of wrapping it all up and meeting with the Department of the Treasury to try to negotiate a final settlement of our differences sometime in April.

There are two distinct differences between DOD and Treasury that I might point out: One is in the area of what rules we use to calculate profit, that is, do we use the rules in section 15 of the Defense Acquisition Regulation, or do we use the IRS rules by which they measure profit for tax purposes?

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Interestingly enough, we prefer the latter, because if we use section 15, many small contractors will have to go through a whole new set of rules with respect to accounting for costs. Yet all of these contractors are taxpayers and use IRS rules for all their tax accounting. We think that a dual effort won't make that much difference, but it certainly will cause contractors a lot of extra work. We think that is totally unnecessary.

The second has to do with the completion of performance of the contract. The IRS would look to partial deliveries constituting a completion and therefore a contractor would have to make determinations throughout the life of the contract and try to allocate costs and profits to units as he delivered them.

We think that is a very arduous way to go about it and would look to the final delivery of the contract when all is said and done, and when the cost results of the contract are known. That would be our approach.

There are some other minor differences, but those are the two fundamental differences between us at the present time. I do not want to imply that our differences cannot be reconciled. This is a continuing process and is not a stalemated negotiation by any means. We are both still trying to convince the other. I think there is room to reach an agreement.

Senator MORGAN. I was going to ask you if you would give us a summary later on of the comments that were received from the interested parties on your proposals. You mentioned that you were preparing a transcript of the hearings. Would that include some of the comments made on your proposals?

Mr. CHURCH. That would include all the comments made at those hearings, yes, sir.

Senator MORGAN. If you have any written comments that were submitted outside of the hearings, we would like to have those, too.

Mr. CHURCH. Yes, sir; we will provide those.

[The information is retained in committee files.]

Senator MORGAN. Is it the Department's view that under the law DOD and Treasury must agree on the proposed regulations drafted by IRS before they can go into effect, or is your role merely advisory in this matter?

Mr. CHURCH. We believe that the statute clearly requires that we reach agreement with the Department of the Treasury regarding the method of computing excess profit. We think that can be done.

I do not want to give the impression that somehow we are deadlocked in disagreement with the Department of the Treasury; we are not.

Senator MORGAN. Let us look at current profit levels now, as we understand them to be.

Have you estimated the amounts that would be recovered as excess profits under this Vinson-Trammell Act if it were applied, for example, to contracts for ships and aircraft completed in the calendar year 1979?

Mr. CHURCH. In looking at the 1934 act. what would be the estimated recoupment of profits? I would like to ask Major Jacobs to answer that.

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Senator MORGAN. Major?

Major JACOBS. We cannot provide that information, Senator, because we do not have access to information on what the profits are on the completed contracts to which the act would apply.

We, of course, do have profit data on what we think we negotiate when a contract starts, but we don't have the data that reflects the profit when a contract is completed.

Mr. CHURCH. Many of these contracts would be of the fixed price variety. Literally once a contract is negotiated that is the last audit. It is only when we have a cost reimbursable type contract that we would know what actual profit was finally realized.

Senator MORGAN. Do you have any way of forming an opinion or conclusion as to whether or not there would be substantial excess profits recovered if this act were to stay in place?

Mr. CHURCH. It is hard to look credible and say you can't compute them and then in the next breath say they would be substantial. Our earlier studies that have been done by people such as the Logistics Management Institute, indicate that final profit levels are well below the Vinson-Trammell limitations of 10 percent and 12 percent. In the fixed price area, one would have to guess, and it is just a pure guess based on those studies, that not very many of those individual contracts are going to be over 10 or 12 percent. All we see are the averages and the averages are far below that.

We might have a few that would go over that but we don't really know and I would guess the amount is far less than the cost of administration.

Senator MORGAN. In other words, it would be your estimate now that the amount would probably be less than it would cost to administer the act?

Mr. CHURCH. If I had to guess that would be my guess, yes.

Senator MORGAN. Do you know what the average profit on defense contracts is and does that average profit vary from item to item? Or how does it vary?

Mr. CHURCH. We have records of what our markup is, that is the profit negotiated as we go in. We do not have records on realized profits because as I said, contractors are not very excited about letting you know what they have done on a fixed price contract. When Logistics Management Institute performs a study, we set statistics back not by contract but in total. I say again that the averages are far less than the Vinson-Trammell limitations. The profit objective numbers are typically in the range of 6 to 12 percent depending on what kind of contract it is. On cost reimbursable contracts it is about 7 percent. On fixed price contracts it is roughly about 11.5 percent.

Between 11 and 12 percent, around 11.5 and around 7 percent or slightly under on cost reimbursement contracts depending on whether they have incentive clauses. So, profit objectives are typically under the 10- and 12-percent limitations respectively.

Senator MORGAN. I am familiar with some of the difficulties that the Renegotiation Board had, but in your own judgment have there been specific instances in the last 5 or 10 years where you feel that there have been contracts for ships or aircraft on which excessive profits were realized?

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Mr. CHURCH. I know of no specific instances on contracts for ships or aircraft where excessive profits have been realized. As a matter of fact, as the chairman probably knows in both of those areas, the typical profit is far less than the limitations. Even the going in profit is far less than the limitations.

Senator MORGAN. The theory of Vinson-Trammell in renegotiation is to compute the profit actually earned after the fact and then make a judgment as to whether or not it was excessive. Many have argued that this process is not necessary or desirable in the context of a contracting system that contains many controls at the negotiation stage. I think you addressed some of these, truth in negotiation, cost accounting standards and some other safeguards.

Do you subscribe to the view that these standards and safeguards are adequate?

Mr. CHURCH. As I testified earlier, I think that they are excellent tools coupled with a professional work force which applies them very well. There are a few sole source situations where the Government is placed at a disadvantage; when DOD is in a hurry to try to meet a national security objective, can take advantage of the situation and put in, and I don't mean to imply dishonesty, but simply put in every single contingency that he might face. If in fact those contingencies don't come to bear then he achieves a windfall situation, that is, he did nothing to particularly earn them. He just put big numbers in his price to start with.

Now in a sole source environment, unfortunately the contractor's motivation to get his costs up to the highest level is the same whether or not you have a profit limitation. That is, if he is prone to do that and you are in a sole source environment, you don't demote him or promote him to get his costs up because still the going in profit objectives are likely to be numbers that are going to be within even a 15-percent kind of guideline. But it is in those few sole source situations that I think public confidence needs to be placed in a statutory profit limitation so that they know that contractors cannot simply take advantage of unearned or exploited situations.

Senator MORGAN. That is one of the areas that we will be looking at as we work on this bill.

Let me go back to your statement. In your statement you indicated that it would be your preference, and I assume you speak for the administration on this, you said it would be your preference to have a profit limitation system that focuses only on sole source contracts. I don't understand in theory why it is not possible to have unexpected or unanticipated profits above a reasonable level on a competitively negotiated contract or even on sealed bid contracts. Should we not be focusing on the end result here and not necessarily the type of contract involved?

Mr. CHURCH. No; quite frankly we believe that where there is a competitive market situation, competition will serve to keep costs and profits reasonable. Public Law 87-653, the cost and pricing data statute, does not apply to those contracts either. We like to take advantage of the commercial marketplace and the pressures that it creates to keep prices and profits reasonable, and we do.

Where we do, we cut down on administrative costs. If there exists the rare situation where a contractor was able to compete and still get a

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good profit, then perhaps it might be argued that in a way he has earned it; that in the context of the market environment that he does it so much better than his competitors that he is able to achieve a lower cost, and I think that is part of the American free enterprise system and we do not want to concern ourselves with that.

Senator MORGAN. Suppose you are dealing with a situation in which you do have competitive bids, you are dealing in a new field of technology where the reasonable cost estimates of some components or parts are not actually available. It later turns out that the cost estimates, even where you had more than one bidder, were grossly in error, does it not seem reasonable that there ought to be some way to limit or recover the profits or recover some of the excess profits? Do you follow what I mean?

Mr. CHURCH. What you are describing is a situation which is really not competitive. It is not a competitive environment in the way that we define it with our rules pursuant to Public Law 87-653. You are getting into the area where you have more than one source but it is not adequate price competition as we would define it. Just because you have more than one potential supplier, it does not mean that a contractor would be exempt from profit limitation. In those few circumstances you are describing, you are in that area that can be described as not having adequate price competition within the meaning of the exemption.

Senator MORGAN. Do you think the description "adequate competition" would be able to cover such a situation?

Mr. CHURCH. As Major Jacobs was pointing out you have to limit it to price competition.

Senator MORGAN. In your prepared statement you said that a large number of subcontractors, in your opinion, would not participate in defense work if these profit limitations contained in this Vinson-Trammell Act were left intact. Could you describe a little more fully the study that brought you to this conclusion?

Mr. CHURCH. They were surveys conducted by some of our industry associations and maybe Major Jacobs remembers some of the names of the associations.

Major JACOBS. It was the American Electronics Association that conducted the survey. It is an association that compromises a much larger number of smaller electronic companies than does the Electronics Industries Association (EIA).

Senator MORGAN. I rather suspect that some of these contractors might have little choice inasmuch as most of their work may very well be for the Defense Department. But that is something we can look at.

Mr. CHURCH. At the subcontract level they usually have a broader base although obviously there are some subcontractors who have no choice. It is where they have a product that is sold in several markets, like a standard component manufacturer, which would cause a great deal of difficulty. They may even opt not to provide us with some of their components which indeed are some of the finest we can have, and deny us the technology that we badly need to incorporate in our systems.

Senator MORGAN. The studies you indicated were made by trade associations. Has the Department done any independent study or studies on this question?

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Mr. CHURCH. Not as such, although we have been deluged in the last 2 or 3 years with the potential activation of Vinson-Trammell by many people who have pointed out to us the problems it creates and the hardship on all of our contractors, particularly the small contractors.

Senator MORGAN. Moving on to the cost of compliance, Mr. Church—we are going to be hearing from the industry a little later on in these hearings—I want to ask you whether you have any estimate of the cost of complying with the Vinson-Trammell reporting and record-keeping requirements and will these reports require different types of accounting procedures or data than that required for other contract compliance purposes?

Mr. CHURCH. Our estimate was $80 million a year. We also pointed out, as did some of the earlier witnesses on giving that figure, that the number could easily be two or three times that. We just don't know how many of our contractors will be affected. We know the number is large. As far as additional paperwork, clearly it requires additional forms, additional accounting records for the contractor to fill out and for us to review and to audit.

Senator MORGAN. I know that you have worked with IRS in developing these proposed regulations to be implemented under Vinson-Trammell. Let me ask you a few questions about some of the possible problems of administration. First, as you mentioned in your statement, the problem of subcontractors who supply components, only some of which are destined for ships or aircraft. Are there other problems associated with the limitation of the ships and aircraft? Has the issue been litigated during the 2 years that the act was in effect during World War II or after World War II?

Mr. CHURCH. There was some litigation in the 1930s. What there was was totally inappropriate for today's time so there is very little to guide us from the period of the time when the act was in force. Clearly at the $10,000 threshold, there are hundreds of thousands of orders that are placed not only by ourselves, but by prime contractors and their first and lower tier subcontractors that would be affected. At that level many of those contractors don't account for a product in terms of a particular batch, or items that come off our line versus another.

They do accounting by a product line, and as such it would be extremely difficult for them, and they would have to put in a very costly accounting system, to try to account separately for what they sold to the Defense Department. They would in all likelihood tell us to take our business elsewhere.

Senator MORGAN. Isn't it likely in some cases you would be buying certain components to be used in ships or aircraft and at the same time you would be using the same components for other purposes?

Mr. CHURCH. Quite clearly.

Senator MORGAN. Those that go in ships and aircraft would be limited by Vinson-Trammell. Those going for other purposes would not.

Mr. CHURCH. Quite clearly.

Senator MORGAN. The IRS regulations seem to require that incentive awards be added to the contract price in computing liability. Do you think this is wise in your view? Is it required by the act?

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Mr. CHURCH. The act does not exempt incentive awards. I think it is a bad idea just on the face of it. I am in favor, if at all possible, of exempting any kind of incentive provisions or awards from any kind of profit limitation whatsoever, Vinson-Trammell or otherwise.

Senator MORGAN. One of the most frequently heard criticisms is that the Vinson-Trammell Act actually encourages contractors to inflate costs. Do you agree that it has that effect or could have? If you do, give us an example of what you are thinking of.

Mr. CHURCH. That line of reasoning assumes that since excessive profits are defined as a percentage of cost, then to get profit down relative to cost, the best way to do it is to increase costs. Of course that is true in almost any sole source environment. As I pointed out earlier, typically the negotiation for the profit is based on a percentage of the estimated cost. We are looking at that in our new profit policy which is a whole new subject. I won't try to bring that one up today but we are very concerned that some of our procedures may demotivate rather than motivate contractors to cut costs. We would like to see them be able to retain profits that they would have achieved had they not found a way to cut costs. We don't want to cut their profit at the same time because then there is no motivation for them to cut costs.

Senator MORGAN. If the Congress should decide to keep this bill or to enact some alternative bill, would it be better to compute profit in some other way, such as percentage of capital investment or equity? Would this in any way encourage companies to hold down the costs?

Mr. CHURCH. The problem with that approach is that you have so many variations in return on investment from one sector of the economy to the next. Some contractors require very high investment. Others require very little investment. It does not make sense to try to motivate contractors to increase their investment to get a higher percentage of profits if they don't need to make the investment. In practically every SIC code you would have to determine what would be an appropriate profit on equity or profit on investment, then you have to look at rates of cash flow.

As a matter of fact, most businesses do a lot of their profitmaking through very effective cash management systems where they turn their money over the maximum number of times each year. You have to include all these factors; it gets to be a very complex formula. I don't see how you could compute profit that way without looking into those various factors.

Senator MORGAN. You know, we have one bill to completely eliminate the Vinson-Trammell Act. We have another one to suspend part of it or to increase the limit, the minimum limit, and others to modify it. If the Congress should see fit to modify it or to enact some similar piece of legislation, some form of profit limitation, would you prefer that it be administered by DOD or by IRS?

Mr. CHURCH. Clearly, we in DOD feel that we are not only qualified, but in the best position to administer it. I know from my discussions with the IRS they would be more than pleased to have us do so.

Senator MORGAN. I am sure they would but would it not put you in an awkward position to negotiate the contract in the first place and then turn around and decide whether or not there has been an excess profit made?

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Mr. CHURCH. If we do have a profit limitation, and I do support a simple one, it should be simple enough that the administration would not require a large staff to look at it; that would be an objective sort of test; one that would be straightforward and would not be subject to allegations of manipulation. Hopefully such a limitation could be administered on a self-certification basis, where the contractor would be the one that would trigger the review and there would be so few reviews that the staff requirement would be very minimal and could be done with a minimum disruption of the DOD process.

Senator MORGAN. You don't think your original negotiators would be less careful because they feel they could pick it up later on if they made a mistake or if the profits were greater than they had anticipated?

Mr. CHURCH. No; because first of all the going in profit position is far less than a number like 15 percent; our profit objectives are currently about 10.5 percent. So, at least with the 15 percent that Congressman Patterson has proposed you are high enough above the going in profit position of negotiations that there certainly is no incentive for negotiators to be less careful because of profit limitation.

Senator MORGAN. Let me ask you a series of questions that we are interested in. What is covered by the Profit Limitation Act? For instance, a radar that goes on a ship, plane, or tank.

Mr. CHURCH. The radar that goes on a ship or plane is subject to the Vinson-Trammell Act unless it has been exempted as an item of scientific equipment. Clearly a radar that goes on a tank is not subject to the Vinson-Trammell Act.

Senator MORGAN. It would not apply at all?

Mr. CHURCH. It would not apply at all.

Senator MORGAN. What is an aircraft? Are missiles included in aircraft?

Mr. CHURCH. All of our interpretations are looking at aircraft as a manned, air-breathing device, not including either remotely piloted aircraft or missiles.

Senator MORGAN. In other words, it would have to be manned aircraft?

Mr. CHURCH. That is our interpretation.

Senator MORGAN. What contracts should be covered under the Vinson-Trammell Act, what subcontracts?

Mr. CHURCH. It would be all that exceed $10,000 in value under the current act.

Senator MORGAN. Should fuel be covered?

Mr. CHURCH. Would fuel be covered?

Senator MORGAN. Yes.

Mr. CHURCH. Maybe Major Jacobs can answer that one. I think that if it is in the ship when it is accepted, it is covered, but if the ship sails out of port and then comes back and gets filled up, then the fuel is not covered. Isn't that right?

Major JACOBS. Yes.

Mr. CHURCH. For example, even such things as the toilet paper and other equipment aboard which are all subject to the act if there is more than $10,000 worth. The ship would have to sail out of port almost empty and at least make one sailing before it gets provisioned.

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Senator MORGAN. That is right. Then if missiles went on the ship they would be covered too if they weren't in the beginning.

Mr. CHURCH. It could be interpreted that way.

Senator MORGAN. What constitutes scientific equipment used for communications, target detection, navigation, or fire control? In other words, this is all avionics?

Mr. CHURCH. Practically all the electronics that go into an aircraft or ship could fall within that definition. Back in 1934 when you looked at what went into a ship or an aircraft, it is different from what it is today. Since we have had almost no interpretations since then, it would be our intent to try to look at the legislative history and intent of the 1934 act for ships and aircraft and try to apply it accordingly. Needless to say we hope that the Congress will take care of this for us.

Senator MORGAN. I was going to ask you what you would consider completion of a contract. You have already indicated that maybe it is the date when the ship sails. Would it be date of delivery, final payment for substantial performance?

Mr. CHURCH. If it were a contract for three ships it should be completion of all three ships, not just one. That is part of our concern with the IRS. They are talking about applying it to partial deliveries against the total contract. Our interpretation would be when all items are delivered and the contract is totally completed and prices and costs are reasonably established, then we add up the contractor's costs and compute what his profit margin is. That is the way we would prefer to define contract completion.

Senator MORGAN. Suppose this Congress does not do anything about the act, would the contracts that were entered into prior to the expiration of the Renegotiation Act be subject to it, if they had been revised since then?

Mr. CHURCH. It is my understanding that the Vinson-Trammell Act applies to receipts and accruals which are not subject to the Renegotiation Act. Clearly some modifications would be subject to Vinson-Trammell.

Senator MORGAN. Suppose they were entered into before that and then you come back and revise the contract? Would you consider that a new contract and subject to the Vinson-Trammell Act?

Mr. CHURCH. If the change was over $10,000 I believe it would be subject to Vinson-Trammell.

Senator MORGAN. What should be the applicability or interface of the cost accounting standards?

Mr. CHURH. Which standards?

Senator MORGAN. Cost accounting.

Mr. CHURCH. How would they affect Vinson-Trammell? I am not sure I understand the question.

Senator MORGAN. How would they interface with the work that would be necessary under Vinson-Trammell?

Mr. CHURCH. I don't see any conflict between cost accounting standards as such and Vinson-Trammell. The conflict gets into IRS rules and how they compute profit for tax purposes versus how we in the Defense Department might view allowable costs with respect to establishing prices. That is where it gets confusing.

Senator MORGAN. Did you hear Congressman Patterson testify or are you familiar with his bill?

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Mr. CHURCH. I heard him testify and I am familiar with his bill also.

Senator MORGAN. Would the Department of Defense give an indication of the scope of this bill in terms of dollar volume and numbers of contracts for fiscal year 1981, noting that the budget authority for procurement contained in the pending fiscal year 1981 Department of Defense budget request is for $40.5 billion?

Mr. CHURCH. We will use the $40.5 billion figure to make that computation, and provide it for the record.

Senator MORGAN. Should a Profit Limitation Act be implemented by including a self-deleting clause in each contract, in which final determinations on applicability would be made by the agency charged with enforcement?

Mr. CHURCH. As I mentioned previously, profit limitation should be on a case-by-case basis with a self-certification provision. We believe, however, that the administering agency should be empowered to make final determinations on applicability and excess profits.

Senator MORGAN. Mr. Secretary, I have a number of specific questions that are generally applicable to the Patterson bill or which relate to them. I wonder if it would not be well if I submitted these questions and asked you to reply for the record so that the staff can have the benefit of your thinking on these.

Mr. CHURCH. Certainly, Mr. Chairman, we shall do so.

Senator MORGAN. We will get these questions to you.

Now in concluding let me get two or three matters straight. Is your opposition to the implementation of the Vinson-Trammell Act as it now stands and your advocacy of a more limited profit limitation system the official policy of the administration?

Mr. CHURCH. Yes, it is, sir.

Senator MORGAN. Is the alternative that you suggest in your statement similar to the bill introduced in the House of Representatives by Mr. Patterson that we talked about earlier?

Mr. CHURCH. Yes; the administration, in principle, supports Congressman Patterson's bill.

Senator MORGAN. If the subcommittee were to opt for some relatively minor changes or revisions in the Vinson-Trammell Act in order to correct some of the more obvious shortcomings and defects that we have talked about, what changes would you recommend as having the highest priority? You may not be in a position to answer that but if you can, good. If you can't, would you do it for the record?

Mr. CHURCH. I think it would be preferable to do that for the record if I could.

[The information follows:]

While we do not believe that minor changes to the Vinson-Trammell Act would correct its many shortcomings, we believe the following changes, in the priority indicated, would relieve prime and subcontractors of a good part of the enormous administrative burden of complying with the act:

1. **Increase the dollar threshold to $5 million.**
2. **Exempt competitive contracts and contracts for commercial items.**
3. **Limit the subcontract flow down to first-tier subcontractors.**
4. **Increase the profit limitation for both ships and aircraft to 15 percent.**

Senator MORGAN. Mr. Secretary, we thank you for coming. We will have additional questions later on. I think that will suffice for today. We appreciate your coming.

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Mr. CHURCH. Thank you, Mr. Chairman.

Senator MORGAN. Mr. Jerome Kurtz, the Commissioner of Internal Revenue.

Mr. Kurtz, we are delighted to have you with us.

STATEMENT OF JEROME KURTZ, COMMISSIONER, INTERNAL REVENUE SERVICE; ACCOMPANIED BY BOB BROWN, OFFICE OF TAX LEGISLATIVE COUNSEL, TREASURY DEPARTMENT

Commissioner KURTZ. Mr. Chairman and members of the subcommittee, I appreciate this opportunity to discuss the administration of the Vinson-Trammell Act.

Under the Vinson-Trammell Act, the Treasury Department is responsible for the collection of any excess profits on Government contracts for the construction of naval vessels and aircraft or portions thereof. Excess profits are defined for purposes of the act as profits in excess of 10 percent on contracts for naval vessels or portions thereof, and in excess of 12 percent on contracts for aircrafts or portions thereof. Contracts are subject to the act if they involve a contract price of $10,000 or more.

The act was passed in 1934. The profit limitations in the act were suspended October 8, 1940, to January 1, 1946, during the existence of the excess profits tax. These limitations were again suspended by the Renegotiation Acts of 1948 and 1951. Upon expiration of the Renegotiation Act of 1951 on September 30, 1976, the profit limitation provisions of Vinson-Trammell came back into effect.

Thus, except for the approximately 2½ years from January 1946 to May 1948, the Vinson-Trammell provisions were suspended for the 36-year period of October 8, 1940, through September 30, 1976.

The existing regulations under the act require that applicable reports be filed within 8½ months after the end of a taxpayer's taxable year. Since the act has again been in effect, the Internal Revenue Service has repeatedly extended the due dates of the reports. During this period, the Treasury Department and Defense Department have worked to update the existing regulations under the act.

Last October, the Treasury Department published proposed regulations. In December, the Department of Defense also published proposed rules and a reporting form and requested comments on two aspects of Treasury's proposals. A hearing on the proposed Treasury regulations is scheduled for March 12, 1980. After all the comments are in, representatives of the Treasury Department and the Defense Department will work to resolve differences and adopt final regulations.

It is generally agreed that the existing act is antiquated. Administration of the act by the Internal Revenue Service could be costly, could require extensive training of our agents in new areas, and would result in the diversion of scarce tax administration resources to a nontax function.

In considering possible alternatives to the act, we hope Congress will seriously consider the costs of involving the Internal Revenue Service at all in the procurement area, diverting the Service from its basic tax administration mission.

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If there are to be legislative changes to the act, we hope they will occur before we incur the further significant costs of implementing the existing law.

This concludes my prepared statement. I will be pleased to answer any questions you may have.

Senator MORGAN. Thank you, Mr. Kurtz. Let me say that we hope that whatever changes are made, will be made prior to the time that you have to go forward because I am not sure what the outcome will ultimately be, but one thing I am sure of is that there will be some changes.

You referred in your statement to its being a nontax function. That is the way it struck me when I saw that IRS would enforce it. If this act is to be retained or some version of it would you prefer that it go back and be enforced by someone else other than the Tax Service?

Commissioner KURTZ. Very clearly.

Senator MORGAN. I thought I knew the answer to that one before I asked you.

In that connection do you think maybe it ought to be an independent entity other than DOD?

Commissioner KURTZ. I think that is really a policy question on which I prefer not to express an opinion. Part of the problem is that all of the issues under the act are issues involving Defense procurement policy about which the Internal Revenue Service has no expertise at all.

Senator MORGAN. Has the Treasury Department taken any official position on whether the Vinson-Trammell Act should be implemented as it now appears on the books?

Commissioner KURTZ. No position different from the administration position.

Senator MORGAN. Then I take it you really don't have any recommendations as to how the act should be changed? You say that the Department has no real expertise in defense acquisition?

Commissioner KURTZ. Yes. We simply find ourselves in the position of an act which has been out of existence almost 40 years and suddenly find ourselves in a position of a statutorily imposed task to perform which is clearly outside the mainstream of our activity.

Senator MORGAN. As a matter of interest I wonder what happened during those 2 years after the war and prior to that under the act.

Commissioner KURTZ. There was administration as evidenced by the fact that there are some litigated cases on the books during that period.

Senator MORGAN. I thought you were going to say you are still litigating. They probably are like some of those in the Renegotiation Board.

Mr. Commissioner, the staff reminds me that you said during your prepared testimony that it would be a burden. I wonder if you have done any actual cost estimates or do you have any more specifics as to how you would go about enforcing it at this time, or is it too early?

Commissioner KURTZ. It is too early. If the act were to continue in effect as it now stands the cost would depend largely on the method of administration. That is, we are told by the Department of Defense that very large numbers of contracts would be involved, most of which

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would be quite small, some of which would be very large. The cost then would relate to the kind of audit coverage that we would have. That is, as you know, with tax returns we audit a very high percentage of extremely large returns and a very low percentage of smaller returns.

We would have to look at the contracts under the act and make some determination of audit coverage. Obviously costs could vary by extraordinary amounts depending on the extent of that audit coverage.

Senator MORGAN. Have you received any outside comments on your proposed regulations?

Commissioner KURTZ. Yes; we have. We have received at last count between 80 and 90 written comments although the comment period is still open. Tomorrow is the last day for written comments.

Senator MORGAN. I don't know what we will do with all of them but I think it would be helpful to the committee if you could supply for the record copies of those.

Commissioner KURTZ. We will be delighted to do that.

Senator MORGAN. You might even summarize them.

Commissioner KURTZ. I am told the comments are being summarized. In any event, we will be happy to furnish them for the record.

[Individual comments were retained in the committee's files; the material to be furnished for the record follows:]

SUMMARY OF COMMENTS, PROPOSED REGULATIONS RE EXCESS PROFITS ON CONTRACTS FOR NAVAL VESSELS OR MILITARY AIRCRAFT

[44 Federal Register 61611]

Ninety-nine comments have been received on the proposed regulations. Virtually all of them oppose the act and its implementation. Apart from opposing implementation, the principal arguments made in one or more of the comments are:

The definition of a "complete naval vessel or military aircraft" should be revised to exclude consumable items, such as stores, missiles, etc., that are not an integral part of vessels or aircraft. Section 160.1(b).

The definition of "contract" should expressly state that foreign military sales are excluded in accordance with Revenue Ruling 79-230 (1979-31 IRB 8) July 30, 1979. Section 160.1(c).

The definition of a "portion of a new complete naval vessel or military aircraft" should be clarified. Section 160.1(k).

The definition of "subcontract" should exclude subcontracts below the first tier. Section 160.1(l).

The regulations should add a definition of the terms "construction and manufacture" to exclude research and development.

The regulations should not be applied as of September 30, 1976, but the date of publication of the final Treasury Decision. Section 160.2.

The term "scientific equipment used for communication, target detection, navigation, or fire control" should be defined. Section 160.4 should provide that the power of the Secretary of a military department to exempt contracts for such scientific equipment should be delegable down to the contracting officer.

The date a contract is completed should be the date the final contract price is agreed upon or when final payment is made, when either of these dates is later than the date of delivery. Section 160.5. Such a rule would permit contractors to determine their profits before having to file any reports.

Liability for excess profits should not be imposed on contract bonuses received under clauses which provide that the contractor share in cost savings resulting from an improvement in methods of completing contracts. Section 160.6.

The regulations should adopt tax accounting or generally accepted accounting principles as the basis for determining cost rather than DAR rules. Section 160.9.

The computation of the income tax credit should be revised to permit a credit in cases in which no tax has been paid. Section 160.11.

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The liability of a prime contractor who fails to require its subcontractor to agree to the limitations of the act should be modified. Section 160.12. When the prime contractor has no alternative in the selection of a subcontractor, the requirement of the act should be waived if the subcontractor otherwise refuses to enter into the contract.

The requirement to keep books and records should be limited to a specific number of years to reduce recordkeeping burdens. Section 160.14.

The regulations should permit a consolidated group of corporations to file Vinson-Trammell Act returns on a consolidated basis. Sections 160.15 and 160.16. Consolidated filing would permit the profits and losses from wholly-owned affiliates to be aggregated.

Senator MORGAN. Now I believe Mr. Church testified on a couple of points in your proposed regulations about which you and DOD disagree. Did you hear his discussion?

Commissioner KURTZ. Yes, I did.

Senator MORGAN. Did he discuss them fairly accurately? Could you comment on that?

Commissioner KURTZ. There is one point on which right now the regulations do differ and that is on the determination of cost, whether the tax rules or defense contracting rules are to be used. There is a difference and we will work to resolving that difference. On the other point there is probably an ambiguity in our regulations and we are not as far apart as was indicated. That is the question of whether costs need to be computed prior to completion of the contract. We don't think that where there is a contract, say, for three ships, which was the illustration used, which extended over a period of time, that our regulations would require computations prior to the completion or at least substantial completion of that contract.

On the other hand if there is a very large contract for three ships and there are very small pieces of it that hang on at the end, our regulations would not provide that we wait until the last dollar is spent. I think we are closer than was indicated.

Senator MORGAN. Are you in a position now to tell us the difference in the way you would compute the cost if you used your regular tax methods and how the DOD might compute it?

Commissioner KURTZ. You mean some examples of what they would be?

Senator MORGAN. Yes.

Commissioner KURTZ. There are deductions allowed for computation of taxable income which are not allowable, for example, under Defense contracting costs, costs like general advertising, bad debt deductions. Interest expense is a substantial one. There are special provisions in the tax laws which differ from general accounting principles, methods of accelerated depreciation, special writeoffs of pollution control equipment and a vast array of special provisions in the tax law which it was our view had nothing to do with defense contract costing.

The proposed regulations essentially pick up the costing rules under the existing regulations, that is, those enacted substantially and contemporaneously with the Vinson-Trammell Act back in the 1930's. While some of the concepts may be rewritten to some extent, they are essentially accounting type costs rather than Internal Revenue type costs.

Senator MORGAN. Mr. Kurtz, if I understand the staff correctly and understand your position correctly, IRS would be inclined to apply DOD rules on cost and DOD does not want to use their own rules, they prefer to use your rules?

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Commissioner KURTZ. That is correct.

Senator MORGAN. Now under which set would the profits be the highest?

Commissioner KURTZ. DOD's. Using the tax rules, that is the DOD's position, would generally permit higher profit to be retained by the contractor.

Senator MORGAN. In other words, you would allow, as you mentioned, certain items as advertising, et cetera, that would not be allowed under DOD's rules?

Commissioner KURTZ. When you say we—under the Internal Revenue Service's proposed regulations we would apply defense acquisition rules, and defense acquisition rules would generally provide for lower allowable costs and therefore lower profits to be retained by the contractor than applying Internal Revenue Code cost rules.

Senator MORGAN. Would you be in a position to submit for the record a summary of some of the more significant differences?

Commissioner KURTZ. Yes; surely.

[The information follows:]

COMPARISON OF CERTAIN ITEMS AS ALLOWABLE COSTS

The following paragraphs illustrate the difference in treatment of certain particular items as allowable costs under the DOD approach, under ASPR, and under the existing regulations under the Vinson-Trammell Act.

1. *Advertising expense.*—Section 162 of the Internal Revenue Code generally allows a deduction for all ordinary and necessary advertising expenses in the year incurred and paid or accrued.

Section 15–205.1 of ASPR states that, as a general rule, advertising expenses are not allowable contract costs. An exception is made for such costs if they are directly related to performance of the contract (i.e., advertising for scarce resources or for recruitment of personnel required for performance of the contract).

Existing regulations under the act do not allow selling expenses (which would include advertising expenses) except to the extent they are connected with manufacturing. Generally, advertising expenses are seen as marketing, not manufacturing, costs.

2. *Bad debt expenses.*—Internal Revenue Code section 166 permits a deduction for bad debts in the year in which they become worthless. Alternatively, a deduction for a reasonable addition to a reserve for bad debts is permitted.

ASPR section 15–205.2 does not permit consideration of bad debts arising from uncollectible customers' accounts and other claims in the determination of cost, because these losses are not attributable to the performance of the Government contract. These losses are attributable to the contracts represented by the customers' accounts.

Existing regulations under the act do not allow the treatment of bad debts as indirect costs.

3. *Interest expense of contractor.*—Code section 163 permits interest expense to be deducted in the year incurred or paid, subject to special rules for some limited situations.

ASPR section 15–205.17 disallows interest on borrowings as an indirect cost of a Government contract.

Existing regulations under the act disallow interest expense as an indirect cost.

4. *Cost of idle capacity.*—Under the Internal Revenue Code, cost of idle capacity would generally be considered deductible or depreciable.

ASPR disallows the cost of idle facilities and capacity unless such is necessary to meet fluctuations in workload or was initially necessary but changes of program requirements, etc., caused the idleness. If change is the reason for the idle capacity or facility, the allowance cannot exceed one year.

Existing regulations under the act disallow the cost of maintaining excess facilities not adaptable for future use.

5. *Entertainment expenses.*—Internal Revenue Code section 162 permits treating entertainment expenses, if properly substantiated, as a cost of doing business.

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ASPR section 15-205.11 disallows the cost of social activities, including meals and lodging, unless the cost is incurred (1) at meetings where the primary purpose is dissemination of technical information, or (2) the cost is part of dormitory, etc. services for employees.

Existing regulations under the act disallow entertainment expenses.

6. Contributions and donations.—Internal Revenue Code section 170 permits deductions for charitable contributions by corporations, not exceeding 5 percent of taxable income (as adjusted under section 170). A 5-year carryover period is allowed for excess contributions.

ASPR section 15-205.8 disallows such contributions and donations.

Existing regulations under the act disallow such donations except donations to local charitable or community organizations to the extent constituting ordinary and necessary business expenses.

7. *Depreciation expense.*—Internal Revenue Code section 167 allows accelerated depreciation by the first user of property used in a trade or business, and straight-line depreciation by subsequent users. In addition, the ADR system permits use of a shorter economic life than is justified by the true period in which an asset is economically viable. Also, there are a number of special amortization provisions which accelerate recovery of the cost of property to a period even shorter than accelerated depreciation gives.

ASPR section 15-205.9 permits normal depreciation of costs properly allocable to the contract. Any method of depreciation acceptable for federal income taxes may be used, but allowable depreciation cannot exceed the amounts claimed for book and financial statement purposes. (Frequently this is less than the amount claimed for income tax purposes.)

Existing regulations under the act permit normal depreciation deductions with respect to property used in production under the contract with no discussion to the method to be used.

8. *Self-insurance.*—Section 162 of the Internal Revenue Code generally allows a deduction for ordinary and necessary expenses actually paid or incurred. Thus, money set aside for selfinsurance is generally not allowable under tax accounting principles.

Section 15.205.167 of ASPR states that, as a general rule, provisions for a reserve under an approved self-insurance program are allowable to the extent that the types of coverage, extent of coverage, and the rates of premiums would have been allowed had insurance been purchased to cover the risks.

Existing regulations under the act allow the cost of self-insurance for certain unemployment insurance and workman's compensation insurance. Other self-insurance is allowed only to the extent of actual losses suffered.

Senator MORGAN. I certainly would like to have a case like this before a jury and say my opponent's rules are so bad that he doesn't even want to apply them himself. But I would only do that if I had the last speech.

Commissioner KURTZ. I was going to say we apply the rules we are given but I won't say that.

Senator MORGAN. Mr. Kurtz, thank you very much. Your testimony has been helpful. As you heard me say earlier, we are just laying the foundation today. We are going to have to look over what we have and come back. We may be coming back to you or to the staff for additional help.

Commissioner KURTZ. I will be glad to be as helpful as we can, Mr. Chairman. Thank you.

[Questions with answers supplied follow:]

QUESTIONS SUBMITTED BY SENATOR ROBERT MORGAN, ANSWERS SUPPLIED BY DALE CHURCH

Senator MORGAN. What is your estimate of the yearly cost to the U.S. Government to enforce the Vinson-Trammell Act?

Mr. CHURCH. We estimate that the annual cost for both Government and industry would be in excess of $80 million.

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Senator MORGAN. What would be the yearly cost to contractors?

Mr. CHURCH. The annual cost to contractors would be the majority of the $80 million I just mentioned. These costs would eventually be passed on to the Government through higher prices.

Senator MORGAN. Can you estimate recoveries to the Government of excess profits over 10 percent on ships and 12 percent on aircraft?

Mr. CHURCH. We have no way of estimating amounts that would be recovered by the Government under Vinson-Trammell. We do not have access to final cost and profit data on competitive and firm fixed price type contracts and subcontracts. Our previous profit studies lead us to conclude that any amounts recovered would be very small. Average profits on defense contracts appear to be substantially below Vinson-Trammell limitations, although a few individual contracts could exceed these percentages.

Senator MORGAN. Since 1950 much has happened to improve procurement practices used by the Federal Government—better trained personnel, better regulations, far more visibility under Public Law 87–653 and cost accounting standards, improved auditing and many other improvements. Considering these improvements would you say that there will likely be excess profits earned by contractors?

Mr. CHURCH. The improvements you mention have certainly contributed to better contract negotiation and administration. They will not prevent excess profits, however, and they do not provide a means to recover such profits should they be realized.

Senator MORGAN. What cost rules will apply to the Vinson-Trammell Act or any successor? Will it be Defense Acquisition Regulation provisions on allowable costs or IRS cost regulations attuned to income tax?

Mr. CHURCH. I believe the IRS regulations governing cost allowability for Federal income tax purposes should also be used to determine costs for calculating excess profits. This is consistent with the rules used under the Renegotiation Act, and prevents a potential double penalty for unallowable costs which would result from not recognizing these costs in both pricing and profit limitation.

Senator MORGAN. Do you see any need for profit-limiting legislation?

Mr. CHURCH. There is a public policy and a practical need for this type of legislation for defense contracts.

Senator MORGAN. Under a profit limitation act, when is a contract complete and is each item (for example, each airplane delivered) a separate contract?

Mr. CHURCH. I assume you refer to the Vinson-Trammell Act. The act does not define contract completion. IRS proposes that the date of delivery of a naval vessel, military aircraft, or portion thereof will be considered as a date of contract completion. This is inconsistent with the way we contract for these items and also the way contractors accumulate contract receipts and costs. We believe contract completion must be some point after delivery of the last naval vessel, military aircraft, or portion thereof required by the contract in order to make any reasonable computation of total contract costs and profits.

Senator MORGAN. What is covered by a profit limitation act:

(a) A radar that goes on a ship, plane, or tank?

(b) What is an aircraft—are missiles covered?

(c) What subcontracts should be covered?

(d) Should fuel be covered?

(e) What constitutes scientific equipment used for communication, target detection, navigation, or fire control?

Mr. CHURCH. (a) A radar that goes on a ship or plane, if it is delivered with the item, and not exempted as scientific equipment.

(b) A military aircraft is defined by IRS as a vehicle used by the Army, Navy, or Air Force that is designed primarily for flight in the atmosphere and that has incorporated into its basic design the ability and requirement for human occupancy. Missiles would be covered if delivered as part of a new, complete military aircraft or naval vessel or part thereof.

(c) Subcontracts over $10,000 at any tier.

(d) Only if acquired under a contract or subcontract over $10,000, and included on a new ship or aircraft.

(e) This terminology was originally intended to apply to such equipment when it involved extensive contractor research and development for perfection, the thought being that Vinson-Trammell profit limitations would not allow adequate recovery of research and development costs.

Senator MORGAN. (a) Does this include all avionics?

(b) Should NASA contracts be covered?

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(c) Would satellites be covered?
(d) What type of service contracts should be covered?
(e) Should only original spares be covered?
(f) What should be considered completion of a contract—date of delivery, final payment, substantial performance, final acceptance?
(g) In terminated contracts, should completion be the date of termination?

Mr. CHURCH. (a) I believe it would include most avionics and components thereof which were not developed at Government expense.
(b) No.
(c) No.
(d) Service subcontracts entered into in connection with naval vessel construction or military aircraft manufacturing would be covered.
(e) Only if delivered as part of a new ship or aircraft.
(f) Delivery of the last naval vessel, military aircraft, or portion thereof required by a prime or subcontract. This does not mean, however, that costs and profits will be known with certainty at this time. As a minimum, the contractor's accounting period should be closed out prior to filing on contracts completed in that period.
(g) It should be this date or another date mutually agreed to by the Secretary of Defense and Commissioner of Internal Revenue or their designated representatives.

Senator MORGAN. What about contracts entered into prior to expiration of the Renegotiation Act and revised thereafter?

Mr. CHURCH. Contract receipts and accruals subject to the Renegotiation Act are not subject to the Vinson-Trammell profit limitations.

Senator MORGAN. What should be the applicability or interface of the cost accounting standards?

Mr. CHURCH. To the extent cost accounting standards are applicable in estimating, accumulating and reporting costs which would be allowable under both Department of Defense and IRS rules concerning cost allowability, they should apply for profit limitation. We should not, however, seek to apply Cost Accounting Standards in determining excess profits when they are not otherwise applicable.

Senator MORGAN. Should a profit limitation act be implemented by including a self-deleting clause in each contract, under which final determinations on applicability would be made by the agency charged with enforcement?

Mr. CHURCH. Yes. This would be the most appropriate means of implementing such an act.

Senator MORGAN. It has been said that DOD would support enactment of H.R. 5433 introduced by Congressman Patterson. Please tell us why? Do you see any need for profit limiting legislation?

Mr. CHURCH. We see H.R. 5433 as a reasonable, equitable and cost effective approach to profit limitation on defense contracts.

Senator MORGAN. Would the Department of Defense give an indication of the scope of this bill in terms of dollar volume and number of contracts for fiscal year 1981—noting that the budget authority for procurement contained in the pending fiscal year 1981 DOD budget request is $40,524,000,000?

An examination of the procurement programs for which funds are being requested would indicate that the overwhelming proportion of these moneys will be obligated under noncompetitive or negotiated contracts—as added increments under present programs with the present contractors. Such examples are the F–14. the F–18, the A–10, the F–15, Army, Navy and Air Force missile programs, the XM–1 tank program and many others. The same result applies to the shipbuilding request which will resut in negotiated procurements even though they may be competitive at some earlier stage.

Under these circumstances, what would be a fair dollar volume to ascribe to coverage under this bill?

Mr. CHURCH. The bill would cover more than the procurement appropriation. We also place operation and maintenance and research and development contracts over $5 million, which would also be covered by the bill. The bill would cover all contracts that are over $5 million and are not price competitive which are funded from the procurement as well as other appropriation accounts. This also includes follow-on contracts for which there may have been an initial price competition. Since contracts for procurement of weapons such as you mentioned tend to be quite large, I believe the Patterson bill would cover at least 75 percent

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of the fiscal year 1981 procurement appropriation, and would involve approximately 400 prime contracts. Approximately 200–300 first tier subcontracts would also be covered.

Senator MORGAN. There should be a demonstrated need based on current facts for any bill including this one to be favorobly considered in the Congress.

Based on what has occurred over the past several years and what can be anticipated under the huge procurement dollar volume requested for fiscal year 1981, could the Department of Defense set forth the past and prospective examples justifying the need for this bill? What is the percentage, for instance, of the negotiated contracts over the past few years where the profit exceeded fifteen percent?

Mr. CHURCH. We are unaware of any specific examples of contracts where excess profits have been realized. We do not have legal access to final cost and profit data for firm fixed price contracts, where we believe there is the greatest likelihood of excess profits being realized. We negotiate a small number of contracts which contemplate a profit in excess of 15 percent. These represent less than 1 percent of the total number of negotiated contracts, and does not mean that final profits will exceed 15 percent.

Senator MORGAN. This bill leaves to the Department of Defense the complete legal discretion as to the definitions of profit and cost.

Would it be the intention of the Department of Defense to allow the same elements of cost under this bill that is allowed by the Internal Revenue Service with respect to profit or loss, or would the Department of Defense disallow certain elements that are allowed by the IRS, such as the cost of interest?

Mr. CHURCH. We believe that for the purposes of the Patterson bill, as well as Vinson-Trammell, that IRS rules governing cost allowability should be used in determining excess profits. We have proposed to recognize interest under Vinson-Trammell, although responses to our proposal have indicated that the IRS rule for allocation interest expenses may not be appropriate. We are studying this matter and may recommend an alternative allocation procedure, or that IRS recognize imputed interest calculated in accordance with Cost Accounting Standard 414, rather than actual interest expenses.

Senator MORGAN. In determining "excess profits," the bill has no provision for cost saving incentives.

Why it is not in the public interest to encourage reductions in cost whch the government must pay in any event?

Mr. CHURCH. It is clearly in the public interest to encourage reductions in cost. Cost incentives, which provide a mechanism for contractors to share in cost reductions, are frequently used in DOD contracts. Where these, and other incentives, are earned under a contract, they should not be subject to recoupment under a profit limitation statute. We believe the language in the Patterson bill provides latitude to exclude such incentives from excess profit computations.

Senator MORGAN. The bill extends no recognition to the risk factors which could well be involved in many negotiated contracts. It might be noted that current law permits a fee up to 15 percent on cost plus fixed fee contracts relating to experimental and developmental R. & D. work—where the situation in effect eliminates the risk by authorizing a fee.

Would it be fair to say that many of the noncompetitive negotiated contracts would involve a greater risk of loss of profit than those negotiated under a cost plus fixed fee arrangement?

Mr. CHURCH. It is true that there is a spread of risk in noncompetitive contracts. For purposes of profit limitation this should be recognized by setting an upper limit of profits which takes this spread into consideration. Previous witnesses have objected to a "formula" approach to determining excess profits, which is a feature of the Patterson bill. I submit that any other method, for example, one which would attempt to consider subjective and argumentative factors, such as risk, or permit aggregation of profits, would be tantamount to resurrecting renegotiations, with all of its problems.

Senator MORGAN. Under this bill, in the event that a critical subcontractor, a forge producer for instance, were to refuse to negotiate for any reason, is the Defense Production Act the sole authority for compelling such a subcontractor to produce parts for the Department of Defense?

What would be the percentage of profit allowed by the Department of Defense in such an instance under the pricing provisions of the Defense Production Act.

Mr. CHURCH. Authority to compel a person to produce articles needed by the

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Department of Defense is also afforded by section 18 of the Selective Service Act of 1948, 50 U.S.C. App. §§ 468 (1976). Section 18, which apparently has never been invoked, provides that upon determining that it is in the interest of the national security to obtain prompt delivery of an item authorized for procurement for the Armed Forces, the President may place an order for the item with any plant, mine, or facility capable of its production. The producer is required to give the order the precedence specified in its terms and deliver the items on the dates specified or as soon thereafter as possible. For his performance, the producer is entitled to receive "fair and just" compensation. If the producer fails or refuses to so perform the order, the statute authorizes the President to take possession of the facility and operate it for production of the articles required by the Government.

There are no provisions in the Defense Production Act for establishing prices for profits on contracts directed under title 1 of this act. We would allow profit consistent with our normal profit policy for negotiated contracts in such cases.

Senator MORGAN. Current information would indicate that our country may well be confronted with a problem of severe shortages for critical parts relating to such things as forgings, bearings, semiconductors, metals, and skilled manpower, due in large part to the fierce commercial demand. Critical subcontractors will, therefore, have the election of fulfilling commercial orders rather than defense orders unless they are compelled by law to perform defense work.

Is it the view of the Department of Defense that this bill with a profit limitation and its extensive reports and paperwork is the proper direction as we proceed toward the problem of allocating certain critically short resources needed in part for defense?

Mr. CHURCH. The Patterson bill does not involve a great deal of reports or paperwork in comparison with Vinson-Trammell. The Patterson bill also would in all likelihood not extend to the producers to which you refer. I believe either the exemption for competition, the dollar threshold, or the subcontract tier of these subcontractors would eliminate them from coverage.

Senator MORGAN. Is this bill consistent in all respects with the profit policy of the Department of Defense and the Office of Federal Procurement Policy?

Mr. CHURCH. Yes; with exception of the allowable cost base used to determine profits.

Senator MORGAN. Would the Department of Defense provide for the record a listing and brief description of the current provisions of law relating to profits on defense contracts?

Mr. CHURCH. The only operative statute relating to profits on defense contracts is 10 U.S.C. 2306(d) which limits fees on cost plus fixed fee contracts to 6 percent of the estimated cost of the public work for architect-engineering contracts; 15 percent of the estimated cost for research and development contracts; and 10 percent of the estimated cost for other contracts. I understand the Renegotiation Act is also still on the books, but has not been extended or funded.

Senator MORGAN. Would the Department of Defense also furnish for the record a summary of the current or proposed DOD policy on profits for defense contracts as contained in DOD related circulars or otherwise?

Mr. CHURCH. We will provide for the record a copy of the Defense Acquisition Circular dated February 26, 1980, which contains our recently revised policy on profits on negotiated contracts.

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DEFENSE ACQUISITION CIRCULAR

26 FEBRUARY 1980 NUMBER 76-23

This Defense Acquisition Circular is issued by direction of the Secretary of Defense pursuant to the authority contained in 5 U.S. Code 301, 10 U.S. Code 2202, DoD Directive No. 5000.35 and DAR(ASPR) 1-106.

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ITEM I PROFIT POLICY, INCLUDING FEES UNDER COST-REIMBURSEMENT-TYPE CONTRACTS

Revisions to the DoD profit policy that were announced in DPC 76-3, and subsequently revised in DPC 76-12, recognized, both in profit and as an allowable cost, the facility investment that may be required for efficient contractor operation Designed primarily to apply to contracts for the manufacturing of supplies and equipment, this policy was intended to remove obstacles to cost-reducing facility investment decisions by industry. Since DPC 76-3 was published, experience has indicated that two major changes to the profit policy are necessary These changes involve the weight given to the level of facility investment in reaching a prenegotiation profit objective under the weighted guidelines method and profit policies for research and development and services contracts.

DPC 76-3 stated that the relative weight given the facilities investment factor at that time was modest and that it would likely be increased after industry had an opportunity to adjust its investment patterns Subsequently various studies and reviews have indicated that the weight of the facilities investment factor is not meaningful in contractor investment decisions. The weight range for facilities capital investment (3-808 7) is, therefore, changed from 6 to 10 percent to 16 to 20 percent. The facilities capital factor will now account for about 17 percent of the average profit objective instead of the current 10 percent.

There are many contracting situations in which it is neither desirable nor equitable to apply an investment-oriented profit policy. For example, this is true when relatively few facilities are required for contract performance and no significant productivity gains would be realized by increasing facilities investment The vast majority of these contracts are for labor-intensive research and development and for services These contracts have been excepted from mandatory application of the weighted guidelines method and in FY 1978 accounted for about 27 percent of the dollar value of actions reported on DD Form 1499. The magnitude of these exceptions dictate that a uniform prenegotiation profit procedure be established for these contracts. Accordingly, the exception to the weighted guidelines method in 3-808 2(b) for contracts requiring an insignificant amount of facilities for efficient contract performance is deleted, and new weighted guidelines for labor-intensive research and development contracts and for service contracts are added to the profit policy. The research and development

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weighted guidelines method is essentially the same as the policy which existed prior to DPC 76-3 and should result in profit objectives similar to those arrived at under that policy. The weighted guidelines method for service contracts has been designed to take into account the unique nature of cost inputs and risks associated with contracts for services as opposed to those for manufacturing or research and development.

REPLACEMENT PAGES: 3:139 thru 3:152, 7:70-A, 21:26 thru 21:29, F:231, F:232, F:253.

(NOTE: Part 4, Section XXI, is deleted, effective with this DAC. Last page of Section XXI is now 21:29.)

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under cost-type contracts or not considered as actual costs for final pricing of redeterminable or incentive-type contracts. The action is taken under the price reduction clauses because not only will the increased costs be disallowed or not considered as actual costs but also the fixed-fee or target profit included in the initial price may be subject to reduction in accordance with (1) and (2) above.

(e) In some cases, as where the defective nature of subcontractor data is only disclosed by Government audit, the information necessary to support a reduction in prime contract and subcontract prices may be available only from the Government. To the extent necessary to secure a prime contract price reduction, the contracting officer shall make such information available, upon request, to the prime contractor or appropriate subcontractors. However, if the release of such information would compromise military security or disclose trade secrets or other confidential business information, it shall be made available only under conditions that will fully protect it from improper disclosure, as may be prescribed by: the Office of the Assistant Secretary of the Army (Research, Development and Acquisition), for the Army; Chief of Naval Material (ADCNM for Contracts and Business Management) for the Navy; the Director of Contracting and Acquisition Policy, Headquarters, USAF(AF/RDC) for the Air Force; and the Executive Director, Contracting, for the Defense Logistics Agency. Information made available pursuant to this paragraph shall be limited to that used as the basis for the prime contract price reduction.

(f) Inasmuch as price reductions under the Price Reduction for Defective Cost or Pricing Data clauses may involve subcontractors as well as the prime contractor, the contracting officer shall give the prime contractor reasonable advance notice before making a determination to reduce the contract price under such clauses, in order to afford the prime contractor an opportunity to take any action deemed advisable by him, particularly in connection with any subcontracts that may be involved.

3-808 Profit, Including Fees Under Cost-Reimbursement-Type Contracts.

3-808.1 *Policy.*

(a) *General.* It is the policy of the Department of Defense to utilize profit to stimulate efficient contract performance. Profit generally is the basic motive of business enterprise. The Government and defense contractors should be concerned with harnessing this motive to work for more effective and economical contract performance. Negotiation of very low profits, the use of historical averages, or the automatic application of a predetermined percentage to the total estimated cost of a product, does not provide the motivation to accomplish such performance. Furthermore, low average profit rates on defense contracts overall are detrimental to the public interest. Effective national defense in a free enterprise economy requires that the best industrial capabilities be attracted to defense contracts. These capabilities will be driven away from the defense market if defense contracts are characterized by low profit opportunities. Consequently, negotiations aimed merely at reducing prices by reducing profits, with no realization of the function of profit, cannot be condoned. For each contract in which profit is negotiated as a separate element of the contract price, the aim of negotiation should be to employ the profit motive so as to impel

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effective contract performance by which overall costs are economically controlled. To this end, the profit objective must be fitted to the circumstances of the particular acquisition, giving due weight to each of the effort, risk, facilities investment, and special factors set forth in this 3-808. This will result in a wider range of profits which, in many cases, will be significantly higher than previous norms.

(b) *Contracts Priced on the Basis of Cost Analysis.* When cost analysis is performed pursuant to 3-807.2, profit consideration shall be in accordance with the objectives set forth below. The Government should establish a profit objective for contract negotiations, which will—

(i) motivate contractors to undertake more difficult work requiring higher skills and reward those who do so;

(ii) allow the contractors an opportunity to earn profits commensurate with the extent of the cost risk they are willing to assume;

(iii) motivate contractors to provide their own facilities and financing and to establish their competence through development work undertaken at their own risk and reward those who do so; and

(iv) reward contractors for productivity increases.

The weighted guidelines method set forth in 3-808.2 for establishing profit objectives is designed to provide reasonably precise guidance in applying these principles. This method, properly applied, will tailor profits to the circumstances of each contract in such a way that long-range cost-reduction objectives will be fostered, and a spread of profits will be achieved that is commensurate with varying circumstances.

(c) *Contracts Priced Without Cost Analysis.* On many contracts and subcontracts, good pricing does not require an examination into costs and profits. Where adequate price competition exists, and in other situations where cost analysis is not required (see 3-807), fixed-price-type contracts should be awarded to the lowest responsible offerors without regard to the amount of their profits. Under these circumstances, the profit that is anticipated or, in fact, earned should not be of concern to the Government. In such cases, if a low offeror earns a large profit, it should be considered the normal reward of efficiency in a competitive system and efforts shall not be made to reduce such profits.

3-808.2 *Weighted Guidelines Method.*

(a) *General.*

(1) The weighted guidelines method provides contracting officers with (i) a technique that will insure consideration of the relative value of the appropriate profit factors described in 3-808.4 in the establishment of a profit objective and the conduct of negotiations; and (ii) a basis for documentation of this objective, including an explanation of any significant departure from it in reaching a final agreement. The contracting officer's analysis of these profit factors is based on information available prior to negotiations. Such information is furnished in proposals, audit data, performance reports, preaward surveys and the like. Except as set forth in (b) below, the weighted guidelines method shall be used in the negotiation of all contracts where cost analysis is performed for:

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(i) the manufacturing of supplies and equipment;
(ii) research and development as described in 4-101(a)(1) through (5), encompassing research, exploratory development, advanced development, engineering development, and operational systems development;
(iii) services as described in 4–101(a)(6) and 22-101.

a. The profit objective for manufacturing contracts shall be computed, except as indicated in *e.* below, using the manufacturing weighted guidelines method, which provides profit opportunity based on facilities capital investment.

b. The profit objective for research and development contracts shall be computed using the research and development weighted guidelines method unless, in the judgement of the contracting officer, a significant amount of facilities is required for efficient contract performance, in which case the manufacturing weighted guidelines shall be used.

c. The profit objective for service contracts shall be computed using the service contract weighted guidelines method unless, in the judgement of the contracting officer, a significant amount of facilities is required for efficient contract performance, in which case the manufacturing weighted guidelines shall be used.

d. In determining whether a particular contract shall be classified as manufacturing, research and development, or services, primary reliance shall be placed on the nature of the work to be performed, as indicated by the coding for item 10A of the DD Form 350 (see DOD 4105.61-M, Department of Defense Procurement Coding Manual, Volume 1), notwithstanding the appropriation or negotiation authority used. The following guidelines shall apply:

(i) *Manufacturing Weighted Guidelines.* Contracts coded under Section I, Part C, Supplies and Equipment.
(ii) *Research and Development Weighted Guidelines.* Contracts coded under Section I, Part A, Research, Development, Test and Evaluation, except for contracts coded as AD2-, Defense Services, and A- -6, Management and Support.
(iii) *Services Weighted Guidelines.* Contracts coded under Section I, Part B, Other Services and Construction; and under Section I, Part A, as AD2- and as A- -. Note, however, that there are blanket exceptions for certain services in 3–808.2(b).

e. The categories listed above are intended to be used as a point of departure in determining which weighted guidelines method applies. Many contracts for research and development and for services will require a significant amount of facilities for efficient contract performance. When this is the case, the manufacturing weighted guidelines method shall be used. Similarly, certain contracts for the manufacture of small quantities of high technology supplies and equipment may not require a significant amount of facilities. In such cases, the research and development weighted guidelines method shall be used. Contracting officers shall apply sound judgement in determining which weighted guidelines method is most appropriate for a particular contracting situation. The difference in profit objectives that would result from the applica-

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tion of alternative weighted guidelines methods shall not be a consideration in making this determination.

f. In determining whether a significant amount of facilities is required for efficient contract performance, the contracting officer should assess the facilities needed, including contractor owned and leased and Government owned. When there is a relatively small amount of facilities capital cost of money allocated to the contract because some facilities are provided through operating leases and by the Government, this does not necessarily mean that an insignificant amount of facilities is required for efficient contract performance.

g. When a method other than the manufacturing weighted guidelines method is used to establish the prenegotiation profit objective, the profit objective shall be reduced by the amount of facilities capital cost of money allowed in accordance with 15–205.50. If the contractor does not propose this cost, a provision shall be inserted in the contract that facilities capital cost of money is not an allowable cost (see 3–501, Part I, Section H(iv)). On cost-plus-award-fee contracts, the base fee shall be reduced by the amount of facilities capital cost of money or the contract shall contain a provision to disallow the cost.

(2) The contractor's proposal should include cost information for evaluation and a total profit figure. Contractors shall not be required to submit the details of their profit objectives but they shall not be prohibited from doing so if they desire. Elaborate and voluminous presentations are neither required nor desired and may indicate a low index of cost effectiveness, which fact itself shall be taken into consideration by the contracting officer.

(3) The negotiation process does not contemplate or require agreement on either estimated cost elements or profit elements, although the details of analysis and evaluation may be discussed in the fact-finding phase of the negotiation. If the difference between the contractor's profit objective and the contracting officer's profit objective is relatively small, no discussion of individual factors may be necessary. If the negotiating parties' objectives are relatively far apart, a disclosure of weightings and rationale by both parties may be made concerning the total assigned to contractor effort, contractor risk, facilities investment, and special factors. By thus developing a mutual understanding of the logic of the respective positions, an orderly progression to final agreement should result. Simultaneous, not sequential, agreement will be reached on cost, any incentive profit-sharing formulas or limitation on profits, and price. The profit objective is a part of an overall negotiation objective which, as a going-in objective, bears a distinct relationship to the target cost objective and any proposed sharing arrangement. Since the profit is merely one of several interrelated variables, the Government negotiator shall not complete the profit negotiation without simultaneously agreeing on the other variables. Specific agreement on the exact weights or values of the individual factors is not required and shall not be attempted.

(b) *Exceptions.*

(1) Under the following listed circumstances, other methods for establishing profit objectives may be used.

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(i) Architect-engineering contracts;
(ii) Management contracts for operation and/or maintenance of Government facilities;
(iii) Construction contracts;
(iv) Contracts primarily requiring delivery of material supplied by subcontractors;
(v) Termination settlements;
(vi) Cost-plus-award-fee contracts;
(vii) Contracts not expected to exceed $100,000; and
(viii) Unusual pricing situations where the weighted guidelines method has been determined to be unsuitable. Such exceptions shall be justified in writing and shall be authorized by the head of the contracting activity.

(2) If the contracting officer makes a written determination that the pricing situation meets any of the circumstances set forth above and that application of the manufacturing weighted guidelines will result in an inequitable profit objective, other methods for establishing the profit objective may be used. These methods shall be supported in a manner similar to that used in the weighted guidelines (profit factor breakdown and documentation of profit objectives); however, investment or other factors that would not be applicable to the contract shall be excluded from the profit objective determination. It is intended that the methods will result in profit objectives for noncapital intensive contracts that are below those generally developed for capital intensive contracts.

(c) *Application to Subcontracts.* The prime contractor may use the weighted guidelines or a structured approach that discriminates among different levels of investment if the acquisition would be subject to the weighted guidelines under a prime contract. (For applicability see 3-1300.1(c).) If the acquisition falls into one of the exceptions to the weighted guidelines in 3-808.2(b)(1), the prime contractor may use another method to establish profit objectives. In the absence of a structured approach that discriminates among different levels of investment, similar to the weighted guidelines, the profit objective will be reduced by the amount of facilities capital cost of money allowed in accordance with 15-205.50.

(d) *Limitation.* In the event this or any other method would result in establishing a fee objective in violation of limitations established by statute or this regulation, the maximum fee objective shall be the percentage allowed pursuant to such limitations. (See 3-405.) No local administrative ceilings on profit shall be permitted.

3-808.3 *Profit Objective.*

(a) A profit objective is that part of the estimated contract price objective or value which, in the judgment of the contracting officer, is appropriate for the acquisition being considered, covering the profit or fee element of the price objective. This objective should realistically reflect the total overall task to be performed and the requirements placed on the contractor. Prior to the negotiation of a contract, change order, or contract modification where cost analysis is undertaken, the negotiator shall develop a profit objective. The weighted

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guidelines method, if applicable, shall be used for developing this profit objective. If a change or modification is of a relatively small dollar amount and is basically the same type of work as required in the basic contract, the application of the weighted guidelines method will generally result in a profit objective similar to the profit objective in the basic contract and, therefore, this basic rate may be applied to the contract change or modification. In cases where the change or modification calls for substantially different work, then the basic contract profit and the contractor's effort may be radically changed and a detailed analysis is necessary. Also, if the dollar amount of the change or contract modification is very significant in comparison to the contract dollar amount, a detailed analysis shall be made.

(b) Development of a profit objective should not begin until after a thorough—

(i) review of proposed contract work;

(ii) review of all available knowledge regarding the contractor, pursuant to Section I, Part 9, including capability reports, audit data, preaward survey reports and financial statements, as appropriate; and

(iii) analysis of the contractor's cost estimate and comparison with the Government's estimate or projection of cost.

3-808.4 *Profit Factors.*

(a) The following factors shall be considered in all cases in which profit is to be specifically negotiated. The weight ranges listed after each factor shall be used in all instances where the weighted guidelines method is used.

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	WEIGHT RANGES		
	Manufacturing*	R&D	Services
A. CONTRACTOR EFFORT			
Material Acquisition			
Subcontract Items	1 to 5%	1 to 5%	1 to 5%
Purchased Parts	1 to 4%	1 to 4%	1 to 4%
Other Material	1 to 4%	1 to 4%	1 to 4%
Engineering			
Direct Labor	9 to 15%	9 to 15%	N/A
Manufacturing			
Direct Labor	5 to 9%	5 to 9%	N/A
Services			
Direct Labor	N/A	N/A	5 to 15%
Overhead	N/A	N/A	4 to 8%
Other			
General Management	6 to 8%	6 to 8%	6 to 8%
B. CONTRACTOR RISK	0 to 8%	0 to 7%	0 to 4%
C. FACILITIES INVESTMENT	16 to 20%	N/A	N/A
D. SPECIAL FACTORS			
Productivity	See 3-808.8(a)	N/A	N/A
Independent Development	1 to 4%	1 to 4%	N/A
Other	-5 to +5%	-5 to +5%	-5 to +5%

* An adjustment factor of .7 is applied to the results of the Contractor Effort evaluation to arrive at the dollar profit objective for this factor (see DD Form 1547). Also see 3-1300.5(a)(2).

(b) Under the weighted guidelines method, the contracting officer shall first measure the "Contractor's Effort" by the assignment of a profit percentage, within the designated weight ranges, to each element of contract cost recognized by the contracting officer. Although certain classifications of acceptable cost, including travel, subsistence, facilities, test equipment, special tooling, federal manufacturers' excise taxes, and royalty expenses, may have been historically excludod from the base upon which profit has been computed, they shall not be excluded when using the weighted guidelines method. Not to be included for the computation of profit as part of the cost base is the amount calculated for the cost of money for facilities capital. How this cost is determined and how it will be applied and administered is fully set forth in 3-1300.

(c) The suggested categories under the Contractor's Effort are similar to those on the Contract Pricing Proposal (DD Form 633). Often, individual proposals will be in a different format, but, since these categories are broad and basic, they provide sufficient guidance to evaluate all other items of cost.

(d) After computing a total dollar profit for the Contractor's Effort, the contracting officer then shall add the specific profit dollars assigned for cost risk, facilities investment risk, and special factors. Weighted Guidelines Profit/Fee Objective (DD Form 1547) is to be used, as appropriate, to facilitate the calculation of this profit objective. (See F-200.1547.)

(e) The weighted guidelines method was designed for arriving at profit or fee objectives for other than nonprofit organizations. However, if appropriate adjustments are made to reflect differences between profit and nonprofit

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organizations, the weighted guidelines method can be used as a basis for arriving at fee objectives for nonprofit organizations. Therefore, the policy of the Department of Defense is to use the weighted guidelines method, as modified in (2) below, to establish fee objectives that will stimulate efficient contract performance and attract the best capabilities of nonprofit organizations to defense-oriented activities. The modifications shall not be applied as deductions against historical fee levels but to the fee objective for such a contract, as calculated under the weighted guidelines method.

(1) For purposes of this subparagraph, nonprofit organizations are defined as those business entities organized and operated exclusively for charitable, scientific, or educational purposes, of which no part of the net earnings inure to the benefit of any private shareholder or individual, of which no substantial part of the activities is carrying on propaganda or otherwise attempting to influence legislation or participating in any political campaign on behalf of any candidate for public office, and which are exempt from Federal income taxation under Section 501 of the Internal Revenue Code.

(2) For contracts with nonprofit organizations where fees are involved, the following adjustments are required in the weighted guidelines method.

(i) An adjustment of –1 percent of the total effort shall be assigned in all cases where the manufacturing weighted guidelines method is used. An adjustment of –3 percent of the total effort shall be assigned in all cases where the research and development or services weighted guidelines method is used.

(ii) The weight range under "Contractor Cost Risk" shall be –1 percent to 0 percent in lieu of 0 percent to 8 percent for contracts with those nonprofit organizations, or elements thereof, identified by the Secretary of Defense or the Secretary of a Department (or their respective designees) as receiving sustaining support on a cost-plus-a-fixed-fee basis from a particular Department or Agency of the Department of Defense.

(f) In making a judgment of the value of each factor, the contracting officer should be governed by the definition, description, and purpose of the factors, together with considerations for evaluating them as set forth herein.

3-808.5 ***Contractor Effort.***

(a) *General.* This factor is a measure of how much the contractor is expected to contribute to the overall effort necessary to meet the contract performance requirements in an efficient manner. This factor, which is apart from the contractor's responsibility for contract performance, takes into account what resources are necessary and what the contractor must do to accomplish a conversion of ideas and materials into the final product called for in the contract. This is a recognition that, within a given performance output or within a given sales dollar figure, necessary efforts on the part of individual contractors can vary widely in both value and quantity, and that the profit objective should reflect the extent and nature of the contractor's contribution

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to total performance. The evaluation of this factor requires an analysis of the cost content of the proposed contract as follows.

(b) *Material Acquisition (Subcontracted Items, Purchased Parts, and Other Material).* Analysis of these cost items shall include an evaluation of the managerial and technical effort necessary to obtain the required purchased parts, subcontracted items, and other materials, including special tooling. This evaluation shall include consideration of the number of orders and suppliers and whether established sources are available or new sources must be developed. The contracting officer shall also determine whether the contractor will obtain the material and tooling by routine orders from readily available supplies (particularly those of substantial value in relation to the total contract cost) or by detailed subcontracts, for which the prime contractor will be required to develop complex specifications involving creative design or close tolerance manufacturing requirements. Consideration shall be given to the managerial and technical efforts necessary for the prime contractor to administer subcontracts and select subcontractors, including efforts to break out subcontracts from sole sources through the introduction of competition. These determinations shall be made for purchases of raw materials or basic commodities, purchases of processed material, including all types of components of standard or near standard characteristics, and purchases of pieces, assemblies, subassemblies, special tooling, and other products special to the end item. In the application of this criterion, it should be recognized that the contribution of the prime contractor to his purchasing program may be substantial. This may apply in the management of subcontracting programs involving many sources, new complex components and instrumentation, incomplete specifications, and close surveillance by the prime contractor's representative. Recognized costs proposed as direct material costs, like scrap charges, shall be treated as material for profit evaluation. If intracompany transfers are accepted at price, in accordance with 15-205.22(e), they shall be evaluated as material. Other intracompany transfers shall be evaluated by individual components of cost, i.e., material labor, and overhead. Normally, the lowest unadjusted weight for direct material is 2 percent. A weighting of less than 2 percent would be appropriate only in unusual circumstances when there is a minimal contribution by the contractor.

(c) *Conversion (Engineering, Manufacturing, and Service Labor).* Analysis of the engineering, manufacturing, and service labor items of the cost content of the contract shall include evaluation of the comparative quality and level of the engineering talents, manufacturing and service skills, and experience to be employed. In evaluating engineering labor for the purpose of assigning profit dollars, consideration shall be given to the amount of notable scientific talent or unusual or scarce engineering talent needed in contrast to journeyman engineering effort or supporting personnel. The diversity, or lack thereof, of scientific and engineering specialties required for contract performance and the corresponding need for engineering supervision and coordination shall be evaluated. Similarly, the variety of manufacturing labor skills required and the contractor's manpower resources for meeting these requirements shall be considered. Service contract labor shall be evaluated in a like manner by

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assigning higher weights to engineering or professional-type skills and lower weights to semiprofessional or other type skills required for contract performance. A weighting in excess of 10 percent for service contract labor will be justified normally only when the quality, skill, and experience of the service contract labor warrants a corresponding weighting under a research and development contract.

(d) *General Management (Overhead and G&A).*

(1) Analysis of these overhead items of cost includes the evaluation of the makeup of these expenses and how much they contribute to contract performance. This analysis shall include a determination of the amount of labor within these overhead pools and how this labor would be treated if it were considered as direct labor under the contract. The allocable labor elements shall be given the same profit consideration that they would receive if they were treated as direct labor. The other elements of these overhead pools shall be evaluated to determine whether they are routine expenses, like utilities, depreciation, and maintenance, and hence given lesser profit consideration, or whether they are significant contributing elements. The composite of the individual determinations in relation to the elements of the overhead pools will be the profit consideration given the pools as a whole. The procedure for assigning relative values to these overhead expenses differs from the method used in assigning values of the direct labor. The upper and lower limits assignable to the direct labor are absolute. In the case of overhead expenses, individual expenses may be assigned values outside the range as long as the composite ratio is within the range.

(2) It is not necessary that the contractor's accounting system break down the overhead expenses within the classifications of engineering overhead, manufacturing overhead, and general and administrative expenses, unless dictated otherwise by Cost Accounting Standards (CAS). The contractor whose accounting system only reflects one overhead rate on all direct labor need not change the system (if CAS exempt) to correspond with the above classifications. In evaluating such a contractor's overhead rate, the contracting officer can break out the applicable sections of the composite rate which can be classified as engineering overhead, manufacturing overhead, and general and administrative expenses and follow the appropriate evaluation technique.

(3) There is a critical factor to consider in the determination of profit in this area. Management problems surface in various degrees and the management expertise exercised to solve them shall be considered as an element of profit. For example, a new program for an item that is on the cutting edge of the state of the art will cause more problems and require more managerial time and abilities of a higher order than a follow-on contract. If new contracts create more problems and require a higher profit weight, follow-ons shall be adjusted downward as many of the problems shall have been solved. In any event an evaluation shall be made of the underlying managerial effort involved on a case-by-case basis.

(4) It may not be necessary for the contracting officer to make a separate profit evaluation of overhead expenses with each acquisition of substantially the same product with the same contractor. Where an analysis of

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the profit weight to be assigned to the overhead pool has been made, the weight assigned may be used for future contracts with the same contractor until there is a change in the cost composition of the overhead pool or the contract circumstances, or until the factors discussed in (3) above are relevant.

3-808.6 *Contract Cost Risk.*

(a) *General.*

(1) This factor reflects the policy of the Department of Defense that contractors bear an equitable share of contract cost risk, and to compensate them for the assumption of that risk. A contractor's risk associated with costs to perform under a Government contract is usually minimal under cost-reimbursement-type contracts. However, as acquisitions progress from basic research through follow-on production and supply contracts, the use of increased contractor-risk-assumption-type contracts is appropriate for increasing the contractor's responsibility for performance. The generally accepted progression of the acquisition spectrum ranging from basic research through supply acquisitions and from cost to firm fixed-price contracts, is shown below:

	TYPE OF EFFORT	TYPE OF CONTRACT
1.	Basic Research	Cost, CPFF
2.	Applied Research	Cost, CPFF
3.	Exploratory Development	Cost, CPFF
4.	Advanced Development	CPFF, CPAF
5.	Engineering Development	CPFF, CPAF, CPIF
6.	Operational System Development	CPIF, CPAF, FPI
7.	First Production	FPI
8.	Follow-on Production	FPI, FFP
9.	Supply	FFP

Research and the various categories of development are defined in 4-101.

(2) In developing the prenegotiation profit objective, the contracting officer will need to consider strongly the type of contract anticipated to be negotiated and the associated contractor risk when selecting the position in the weight range for profit that is appropriate for the risk to be borne by the contractor. This is one of the most important factors in arriving at prenegotiation profit objectives.

(b) *Evaluation of Contractor's Assumption of Contract Cost Risk.*

(1) Evaluation of this risk requires a determination of (i) the degree of cost responsibility the contractor assumes, (ii) the reliability of the cost estimates in relation to the task assumed, and (iii) the complexity of the task assumed by the contractor. This factor is specifically limited to the risk of contract costs. Thus, such risks on the part of the contractor as reputation, losing a commercial market, losing potential profits in other fields, or any risk on the part of the contracting activity, such as the risk of not acquiring an effective weapon, are not within the scope of this factor.

(2) The first and basic determination of the degree of cost responsibility assumed by the contractor is related to the sharing of total risk by contract cost by the Government and the contractor through the selection of contract type. The extremes are a cost-plus-fixed-fee contract, requiring only that the

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contractor use his best efforts to perform a task, and a firm fixed-price contract for a complex item. A cost-plus-fixed-fee contract reflects a minimum assumption of cost responsibility, whereas a firm fixed-price contract reflects a complete assumption of cost responsibility.

(3) The second determination is that of the reliability of the cost estimates. Sound price negotiation requires well-defined contract objectives and reliable cost estimates. Prior production experience assists the contractor in preparing reliable cost estimates on new contracts for similar equipment. An excessive cost estimate reduces the possibility that the cost of performance will exceed the contract price, thereby reducing the contractor's assumption of contract cost risk.

(4) The third determination is that of the difficulty of the contractor's task. The contractor's task can be difficult or easy, regardless of the type of contract.

(5) Contractors are likely to assume greater cost risk only if contracting officers objectively analyze the risk incident to proposed contracts and are willing to compensate contractors for it. Generally, a cost-plus-fixed-fee contract will not justify a reward for risk in excess of 0.5 percent, nor will a firm fixed-price contract justify a reward of less than the minimum on the weighted guidelines. Where proper contract-type selection has been made, the reward for risk, by contract type, will usually fall into the following percentage ranges:

(i) type of contract and percentage ranges for profit objectives developed by using the manufacturing weighted guidelines method:

Cost-Plus-Fixed Fee	0 to 0.5%
Cost-Plus-Incentive Fee	
With Cost Incentives Only	1 to 2%
With Multiple Incentives	1.5 to 3%
Fixed-Price-Incentive	
With Cost Incentives Only	3 to 5%
With Multiple Incentives	4 to 6%
Prospective Price Redetermination	4 to 6%
Firm Fixed-Price	6 to 8%

(ii) type of contract and percentage ranges for profit objectives developed by using the research and development weighted guidelines method:

Cost-Plus-Fixed Fee	0 to 0.5%
Cost-Plus-Incentive Fee	
With Cost Incentives Only	1 to 2%
With Multiple Incentives	1.5 to 3%
Fixed-Price-Incentive	
With Cost Incentives Only	2 to 4%
With Multiple Incentives	3 to 5%
Prospective Price Redetermination	3 to 5%
Firm Fixed-Price	5 to 7%

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(iii) type of contract and percentage ranges for profit objectives developed by using the service contract weighted guidelines method:

Cost-Plus-Fixed Fee	0 to 0.5%
Cost-Plus-Incentive Fee	1 to 2%
Fixed-Price-Incentive	2 to 3%
Firm Fixed-Price	3 to 4%

a. These ranges may not be appropriate for all acquisitions. For instance, a fixed-price-incentive contract that is closely priced with a low ceiling price and high incentive share may be tantamount to a firm fixed-price contract. In this situation, the contracting officer may determine that a basis exists for high confidence in the reasonableness of the estimate and that little opportunity exists for cost reduction without extraordinary efforts. On the other hand, a contract with a high ceiling and low incentive formula can be considered to contain cost-plus-incentive-fee contract features. In this situation, the contracting officer may determine that the Government is retaining much of the contract cost responsibility and that the risk assumed by the contractor is minimal. Similarly, if a cost-plus-incentive-fee contract includes an unlimited downward (negative) fee adjustment on cost control, it could be comparable to a fixed-price-incentive contract. In such a pricing environment, the contracting officer may determine that the Government has transferred a greater amount of cost responsibility to the contractor than is typical under a normal cost-plus-incentive-fee contract.

b. The contractor's subcontracting program may have a significant impact on the contractor's acceptance of risk under a contract form. It can cause risk to increase or decrease in terms of both cost and performance. This consideration shall be a part of the contracting officer's overall evaluation in selecting a factor to apply for cost risk. It may be determined, for instance, that the prime contractor has effectively transferred real cost risk to a subcontractor and the contract cost risk evaluation, as a result, may be below the range that would otherwise apply for the contract type being proposed. This situation will be found to exist only in a few extraordinary situations under circumstances of (i) a follow-on production contract, in which a substantial portion of the total contract costs represents a single subcontract or a few subcontracts, (ii) the fullest incentive reward and penalty feature on cost performance having been passed by the prime contractor to the subcontractor. In an acquisition in which all of those circumstances are found to exist, a lower than usual profit weight may be applied to the aggregate of all recognized costs including the subcontract portion. The contract cost risk evaluation shall not be lowered, however, merely on the basis that a substantial portion of the contract costs represents subcontracts without any substantial transfer of contractor's risk, since this can result eventually in a lessening of the amount of work let on subcontracts.

c. In making a contract cost risk evaluation in an acquisition that involves definitization of a letter contract, unpriced change orders, and unpriced orders, under BOAs, consider the effect on total contract cost risk as a result of having partial performance before definitization. Under some circum-

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stances it may be reasoned that the total amount of cost risk has been effectively reduced. Under other circumstances it may be apparent that the contractor's cost risk remained substantially unchanged. To be equitable, the determination of a profit weight for application to the total of all recognized costs, both those incurred and those yet to be expended, must be made with consideration to all attendant circumstances and not be just the portion of costs incurred, or percentage of work completed, prior to definitization.

d. Time and material, labor hour, and overhaul contracts priced on a time and material basis shall be considered to be cost-plus-fixed-fee contracts for the purpose of establishing a profit weight in the evaluation of the contractor's assumption of contract cost risk.

e. In determining the contract cost risk percentage under CONTRACTOR RISK in profit factors of the weighted guidelines provided in 3-808.4(a), it is appropriate to consider additional risks associated with foreign military sales (FMS). To be recognized, an additional cost risk factor shall be demonstrated by the contractor to be significant and over and above that normally present in DoD contracts for similar items. If an additional cost risk factor associated with FMS is recognized, the total profit under the CONTRACTOR RISK section (3-808.4(a)) shall not exceed the limits set forth in 3-808.6(b)(5) for different types of contracts. For example, when the manufacturing weighted guidelines method is used, the limitation will be 0.5 percent for CPFF contracts, 3 percent for CPIF contracts, 6 percent for FPI contracts and 8 percent for FFP contracts. The additional cost risk factor shall not apply to foreign military sales made from inventories or stocks nor to acquisitions made under DoD cooperative logistics support arrangements.

3-808.7 ***Facilities Capital Investment.*** This element relates to the consideration to be given in the profit objective in recognition of the investment risk associated with the facilities employed by the contractor. Sixteen to twenty percent of the net book value of facilities capital allocated to the contract is the normal range of weight for this profit factor. The key factors that the contracting officer shall consider in evaluating this risk are:

(i) the overall cost effectiveness of the facilities employed;
(ii) whether the facilities are general purpose or special purpose items;
(iii) the age of the facilities;
(iv) the undepreciated value of the facilities;
(v) the relationship of the remaining writeoff life of the investment and the length of the program(s) or contract(s) on which the facilities are employed; and
(vi) special contract provisions that reduce the contractor's risk of recovery of facilities capital investment (termination-protection clauses, multiyear cancellation ceilings, etc.).

To assist in evaluating new investment, the contracting officer should request the contractor to submit reasonable evidence that the new facilities are part of an approved investment plan and that achievable benefits to the Government will result from the investment. New industrial facilities and equipment shall receive maximum weight when they—

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(i) are to be acquired by the contractor primarily for defense business;
(ii) have a long service life;
(iii) have a limited economic life due to limited alternative uses; and
(iv) reduce the total life cycle cost of the products produced for the Department of Defense.

To the extent that the new investment represents routine replacement of existing assets, a lesser weight shall be assigned.

3-808.8 *Special Factors.*

(a) *Productivity.*

(1) *General.* A key objective of the DoD profit policy is to reduce the cost of defense preparedness by incentivizing defense contractors' investment in modern cost-reducing facilities and other improvements in efficiency. To the extent that costs serve as the basis for pricing (both cost and profit), success in reducing costs can serve, in turn, to reduce profit dollars opportunity. For example, a fixed-price incentive-type contract is typically used for the first production contract of a major weapon system program. The incentive to increase productivity and reduce cost within one contract works against a contractor on follow-on production contracts because the reduced level of cost becomes a part of the basis for pricing subsequent contracts. In order to mitigate the loss of profit dollars opportunity that occurs when costs are reduced due to productivity gains, a special "Productivity Reward" may be included in the prenegotiation profit objective of a pending acquisition under certain circumstances.

(2) *Applicability Criteria.* The "Productivity Reward" may be applied when the following criteria are met:

(i) The pending acquisition involves a follow-on production contract.
(ii) Reliable actual cost data is available to establish a fair and reasonable cost baseline.
(iii) Changes made in the configuration of the item being acquired are not of sufficient magnitude to invalidate price comparability.

(3) *Implementation Procedures.* The amount of productivity reward for a given contract is based on the estimated cost reduction that can be attributed to productivity gains. Set forth below are principles and procedures that apply to estimating cost reductions and calculating the productivity reward:

(i) The contractor shall prepare and support the cost reduction estimate.
(ii) The overall contract cost decrease shall be based on estimated decreases measured at the unit cost level.
(iii) The lowest average unit cost (exclusive of profit) for a preceding production run shall serve as the unit cost baseline.
(iv) A technique shall be employed to determine that portion of the cost decrease attributable to productivity gains as op-

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posed to the effects of quantity differences between the base contract and the pending acquisition.

(v) When the parties agree that the estimated overall contract cost decrease is materially affected by price level differences between the base period and the current point in time, an economic price adjustment may be applied to the estimate.

(vi) The productivity reward shall be calculated by multiplying the contract cost decrease due to productivity gains by the base profit objective rate.

(vii) The degree of review and validation of the data supporting the productivity reward calculation shall be commensurate with the materiality of this profit element in relation to the overall price objective.

There may be several methods advanced, by both contracting officers and contractors, to quantify productivity gains. Any technique may be acceptable, provided it takes into account equitably the principles and procedures listed above.

(b) *Independent Development.* Contractors who develop items that have potential military application without Government assistance are entitled to special profit consideration on those items as a special profit factor to be considered within the weighted guidelines in arriving at a profit objective. One to four percent of recognized cost is established as the normal range of value for this profit factor. The criteria for selection of the specific percentage shall be the importance of the development in advancing defense purposes, the demonstratable initiative in determining the need and application of the development, the extent of the contractor's cost risk, and whether the development cost was recovered directly or indirectly from Government sources.

(c) *Other Factors.* A composite percentage weight within the range of –5 percent to +5 percent of the basic profit objective may be assigned to other profit factors in arriving at the total profit objective. These other profit factors, which may apply to special circumstances or particular acquisitions, relate to contractor participation in the Government's Small Business, Small Disadvantaged Business, and Labor Surplus Programs, and to special situations not specifically set forth elsewhere in these guidelines. Participation that is rated as merely satisfactory shall be assigned a weight of zero, generally. Evidence of energetic support may justify a plus weight and poor support a negative weight. Special situations may be assigned either a plus or minus weight depending on the particular circumstances of the acquisition.

(1) *Small Business and Small Disadvantaged Business Participation.* The contractor's policies and procedures that energetically support Government small business and small disadvantaged business subcontracting programs, pursuant to 1-707 and 1-332, shall be given favorable consideration. Any unusual effort that the contractor displays in subcontracting with small business or small disadvantaged business concerns, particularly for development-type work likely to result in later production opportunities, and the overall effectiveness of the contractor in subcontracting with and furnishing assistance to such concerns shall be considered. Conversely, failure or

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unwillingness on the part of the contractor to support Government small business or small disadvantaged business policies shall be viewed as evidence of poor performance for the purpose of establishing a profit objective.

(2) *Labor Surplus Area Participation.* A similar review and evaluation (as required in (1) above) shall be given to the contractor's policies and procedures supporting the Government's Labor Surplus Area Program, pursuant to 1-805.1. In particular, favorable consideration shall be given to a contractor who (i) makes a significant effort to help find jobs and provide training for the hardcore unemployed, or (ii) promotes maximum subcontractor utilization of certified eligible concerns, as defined in 1-801.1.

(3) *Energy Conservation.* Favorable consideration shall be given to the contractor's initiatives and accomplishments in the conservation of energy.

(4) *Special Situations.* Particular situations may justify use of a profit factor other than those specifically identified in these guidelines. These situations shall be identified and the reason(s) for their use documented in the records of price negotiation. Examples of such situations include contractor effort to exploit additional preduction cost-reduction opportunities or to improve or develop new product/manufacturing technologies to reduce production cost.

3-809 Contract Audit as a Pricing Aid.

(a) *General.* Contract audit services are available in two forms:

(i) Audit reports setting forth the results of auditors' reviews and analyses of cost data submitted by contractors as part of pricing proposals, reviews of contractors' accounting systems, estimating methods, and other related matters; and

(ii) "On-the-spot" personal consultation and advice to contracting and contract administration personnel in connection with analyses of contractors' cost representations and related matters by liaison auditors stationed at contracting and contract administration offices.

Contract auditors are professional accountants who, although organizationally independent, are the principal advisors to contracting officers on contractor accounting and contract audit matters. The terms "audit review" and "audit" refer to examinations by contract auditors of contractors' statements of actual or estimated costs to the extent deemed appropriate by the auditors in the light of their experience with contractors and relying upon their appraisals of the effectiveness of contractors' policies, procedures, controls, and practices. Such audit reviews or audits may consist of desk reviews, test checks of a limited number of transactions, or examinations in depth, at the discretion of the auditor.

(b) *Audit Reports on Contractor Price Proposals.*

(1) The auditor's role in the evaluation of contractor pricing proposals is set out in detail in 3-801. The precedures

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(d) One of the following paragraphs shall be added to the Option clause when the Government either knows or anticipates that the option may be exercised to fulfill Foreign Military Sales (FMS) requirements. These added provisions are not required nor shall they be placed into contracts for the establishment or replenishment of Department of Defense inventories or stocks, or procurements made under DoD Cooperative Logistic Support Arrangements.

(1) Insert a paragraph substantially as follows when the Government and the contractor are able to negotiate a price in advance for FMS requirements:

The U. S. Government may exercise the option or options under this clause to fulfill Foreign Military Sales commitments undertaken by the U. S. Government on behalf of a foreign country.

(2) Insert a paragraph substantially as follows when the Government anticipates that the option may be exercised for FMS requirements and the Government and the contractor are unable to negotiate any additional cost or profit considerations attributable to FMS included in 6-1304 and 3-808.6(b)(5)e until a specific country or countries are subsequently identified:

The U. S. Government may exercise the option or options under this clause to fulfill Foreign Military Sales commitments undertaken by the U. S. Government on behalf of a foreign country. At the date of exercise of the option, the U. S. Government will identify the foreign country for the purpose of negotiating an equitable price adjustment for any additional cost or profit considerations attributable to Foreign Military Sales included in 6-1304 and 3-808.6(b)(5)e. Failure to agree to such an equitable adjustment shall be treated as a dispute within the meaning of the clause of this contract entitled "Disputes."

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(f) Purchases from overseas exchange and educational services (*e.g.*, European - Korean Exchange Systems) shall be reported on line 4b of Section A and line 6 of Section B.

21–206 Section B, Negotiated Actions.

(a) Enter the number and dollar amount of negotiated actions of $10,000 or less according to the authority of 10 U.S.C. 2304(a) which was used. The totals of Lines 1 through 17 in Section B shall equal the sums of the entries on Lines 1*b*, 2*b*, 3*b*, and 4*b* in Section A.

(b) The following provision is applicable only to U.S. Army Troop Support Agency Activities. In lieu of separately tabulating nonfood/food transactions for commissary resale items that are reportable under negotiation authority 10 U.S.C. 2304(a)(8) and (9), a ratio of the total shall be reported as follows:

(1) Enter 26% of the total actions on Line 8 and 74% on Line 9.

(2) Enter 37% of the total dollar value on Line 8 and 63% on Line 9.

21–207 Section C, Research Development, Test and Evaluation Actions. (These actions are also reported in Sections A and B). Enter the number and dollar amount of actions of $10,000 or less for research, development, test and evaluation work on Lines 1 through 4. Do not include purchases of supplies or services that are incidental to the fulfillment of RDTE work but do not require contractor RDTE performance (see 21–116(a)).

21–208 Section D, Competition in Negotiated Actions.

(a) Enter on Line 1 the number and dollar amount of actions determined to be price competitive in accordance with the criteria set forth in 21–126(c).

(b) Enter on Line 2 the number and dollar amount of all actions which are not considered to be price competitive.

(c) Enter on Line 3 the sums of entries on Lines 1 and 2 of Section D. The Line 3 totals shall equal the totals on Line 18 of Section B.

21–209 Section E, Minority Business Actions. (See 1–332.2.)

(a) Enter on Line 1 the number and dollar amount of awards made to minority business firms that were made through the Small Business Administration pursuant to the Small Business Act - Public Law 85–536 Section 8(a).

(b) Enter on Line 2 the number and dollar amount of awards made directly to minority business firms.

(c) Enter on Line 3 the sums of the entries in Lines 1 and 2 of Section E.

21–210 Adjustments. Revised DD Form 1057 reports shall not be submitted; but the amounts of corrections or adjustments, if required, shall be included in the report for the following month. If the correction or adjustment results in a net reduction of either action or dollar amounts, enter the symbol "*CR*" following the amount to signify a credit entry.

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PROCUREMENT MANAGEMENT REPORTING SYSTEM

Part 3—Report of Individual Contract Profit (DD Form 1499)

21-300 Scope and Purpose of Part. This part prescribes the reporting on DD Form 1499 (F-200.1499) of cost and profit plans on contract actions of $500,000 or more, negotiated by specified contracting offices. The form provides a basis for analyzing profit patterns and weighted guidelines objectives on defense contracts. As used in this part, the term *cost* includes target cost as well as estimated cost, and the term *profit* includes fee.

21-301 Applicability. DD Form 1499 shall be prepared by each contracting office of the—

(i) Army Materiel Development and Readiness Command, Ballistic Missile Defense Systems Command, Defense Supply Service, Washington, and U.S. Army Corps of Engineers;

(ii) Air Force Logistics and Systems Commands; and

(iii) Naval Air, Sea, and Electronic Systems Commands, Naval Facilities Engineering Command, Naval Regional Contracting Office, Philadelphia. The form also shall be prepared by the following Navy activities of the Naval Supply Systems Command: Navy Aviation Supply Office, Philadelphia; Navy Ships Parts Control Center, Mechanicsburg; and Naval Regional Contracting Office, Long Beach. Contracting offices located outside the United States, its possessions, and Puerto Rico, under the jurisdiction of the above-mentioned commands, are exempt from this reporting requirement.

21-302 Coverage.

(a) A DD Form 1499 shall be prepared by the contracting offices described in 21-301 for each negotiation of a contractual agreement involving a separate cost and profit that together total $500,000 or more. This negotiated total may agree, but not necessarily, with the amount obligated by the contractual instrument. The instrument may be a new definitive contract, an indefinite delivery-type contract, the definitization of a letter contract, or order under a basic ordering agreement, a supplemental agreement, or any other action in which the contracting officer and contractor negotiate an estimated cost and profit. If, in connection with a fixed-price-type contract or contract modification, the contracting officer requires the contractor to submit cost or pricing data pursuant to 3-807.3, a DD Form 1499 shall be prepared showing the contracting officer's best estimate of cost and profit.

(b) If more than one profit rate applies to a negotiation and the amount for each rate is $500,000 or more, a separate DD Form 1499 shall be used to report data for each rate. If the dollar amount for any profit rate of a multirate negotiation is less than $500,000, the data for the amount below $500,000 shall not be reported. If the separation of a contract into different rates produces no portion of $500,000 or more, a report on DD Form 1499 shall not be submitted.

(c) If any reportable negotiation includes a cost or cost-sharing portion or a firm fixed-price portion not reportable pursuant to (a) above, that portion shall not be reported on DD Form 1499. If the application of this provision fragments

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an action so that an otherwise reportable portion is less than $500,000, that portion shall not be reported on DD Form 1499.

(d) A DD Form 1499 shall be submitted if the above conditions are met, even though (i) price competition was used, (ii) weighted guidelines were not used, or (iii) a supplemental agreement involving cost and profit was executed without changing the profit rate applicable to the basic contract.

21-303 Due Date and Distribution.

(a) Contracting offices shall (i) prepare DD Form 1499 as soon as possible after the date of action, (ii) assemble the reports for the month of action, and (iii) forward the reports in duplicate within 10 days after the close of the month as follows:

(1) Army: HQDA (JDHQ-SV-W-P), Washington, D.C. 20310:

(i) Contracting offices under the jurisdiction of DARCOM and the BMDS Command shall report through U.S. Army Materiel Development and Readiness Command, Attn: DRCPP-SC, 5001 Eisenhower Avenue, Alexandria, Va. 22333;

(ii) Contracting offices under the jurisdiction of the U.S. Army Corps of Engineers shall report through the Office, Chief of Engineers, HQDA (DAEN-PRP), Washington, D.C. 20314.

(2) Navy: Headquarters, Naval Material Command, Attn: MAT-08C1D, Washington, D.C. 20360.

(3) Air Force: AFLC/ACOCD, Wright-Patterson Air Force Base, Ohio 45433.

(b) Prior to submission of DD Form 1499, contracting offices shall review the form and associated contract files sufficiently to insure that all reportable transactions are reported and that reports are complete and accurate.

(c) DD Form 1499 shall be submitted as an unclassified document. If the reporting office considers it necessary to apply a security classification to a DD Form 1499, a communication relating the reasons for the classification shall be submitted to the Office of the Assistant Secretary of Defense (Comptroller), Attn: Directorate for Information Operations and Control, through the appropriate organization in 21-303(a). In no case shall security classification be considered a reason for not reporting on DD Form 1499.

(d) The reporting requirements of this part are assigned RCS:DD-R&E(M)1215.

21-304 Specific Entries on DD Form 1499.

(a) *Department.* Enter Army, Navy, or Air Force, as appropriate.

(b) *Item 1, Report No.* Each contracting office identified by a separate number in the item 5 code block shall enter a four-digit number assigned consecutively starting with 0001 at the beginning of each fiscal year. This number shall be followed by the last two digits of the fiscal year. Numbers with less than four significant digits shall be preceded by zeros; e.g., the fourth report in fiscal year 1977 would be numbered 0004–77. This number identifies a specific DD Form 1499 and is not related to any DD Form 350 number.

(c) *Item 2, Contract No.* Enter the contract number in items 2.a., b., c., and d., in the manner prescribed for DD Form 350 in 21-108.

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(d) *Item 3, SPIIN.* Enter in item 3 any order, supplemental agreement, or other modification number in the manner prescribed for DD Form 350 in 21–110.

(e) *Item 4, Date of Action.* Enter in numeric terms the year and month (e.g., 77–03 for 1977 March) when a mutually binding agreement was reached on the estimated cost and profit. For example, this may be the date when—

(i) a new definitive contract was awarded,

(ii) a letter contract was definitized,

(iii) a supplemental agreement was executed,

(iv) a change order was definitized, etc.

(f) *Item 5, Contracting Office Name.* Enter the name of the contracting office submitting the report, and enter in the item 5 code space, the symbol or number assigned to that contracting office in the DoD Procurement Coding Manual, Volume III.

(g) *Item 6, Type of Pricing Action.* Enter in the item 6 code space Code A for the first reportable action pertaining to a contract, i.e., the award of a new definitive contract, a definitive contract superseding a letter contract, or an indefinite delivery-type contract. Enter Code B for all other types of actions, including orders under basic ordering agreements.

(h) *Item 7, Contractor Identification.* Enter the complete name of the concern and, if applicable, the name of the division to which the award was made. Enter in the item 7 code space the first six digits of the contractor code as shown in the DoD Procurement Coding Manual, Volume II. If the contractor is not listed in the manual, no code shall be entered by the contracting office.

(i) *Item 8, Principal Place of Performance.* Enter the actual location of the plant or place of business where the items will be producod or the service rendered in accordance with instructions in 21-113 for DD Form 350. Enter in the item 8 code space the city and State codes shown for the contractor at the specified location in the DoD Procurement Coding Manual, Volume II. If the contractor's name is not listed in the manual, or is listed for a location or locations other than the one reported, no code shall be entered by the contracting office.

(j) *Item 9, Federal Supply Class or Service Code.* Enter the appropriate Federal Supply Class or Service Code from the DoD Procurement Coding Manual, Volume I, in accordance with instructions prescribed for item 10A of DD Form 350 in 21–116.

(k) *Item 10, DD Claimant Program No.* Enter in the item 10 code space the code from the DoD Procurement Coding Manual, Volume I, Section III, that describes the commodity or service called for by the contract.

(l) *Item 11, Weighted Guidelines Category.* Enter in the item 11 code space only one of the Codes A, B, C, or D, to identify the weighted guidelines applicable to the reported action.

(m) *Item 12, Type of Contract.* Enter in the item 12 code space only one of the codes A, J, K, L, R, U, or V to show the pricing provisions applicable to the reported action. If more than one type of pricing applies to a single negotiation, the provisions of 21–302(c) and (d) apply. That is, separate DD Forms 1499 shall be prepared for each type of pricing involving a cost and profit totaling

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$500,000 or more; DD Forms 1499 shall not be prepared for (i) types of pricing with less than aggregate cost and profit of $500,000, (ii) cost-no-fee, or (iii) firm fixed-price without a negotiated cost and profit.

(n) *Item 13, Negotiation Summary.*

(1) Enter dollar amounts applicable to lines a. through f. as proposed by the contractor, the Government's objective, and the negotiated amounts. These entries shall be to the nearest whole dollar; do not show cents, or make entries involving cent positions. For example, $568,035.54 shall be entered as $568,036 and not as $568,036.00; $500,500.49 shall be entered as $500,500.

(2) The dollar entries shall reflect the entire reportable amounts negotiated in the contractual agreement, not merely the portion obligated. Thus, awards contemplating incremental funding shall be reported as total negotiated cost and profit at the time of initial award, not as the amounts initially obligated. However, amounts applicable to options for additional quantities shall be excluded unless the options are exercised. When options are exercised, a report shall be submitted if the amounts meet the dollar threshold of 21-302.

(3) For cost-plus-award-fee (CPAF) contracts, only the base fee shall be reported.

(4) For indefinite delivery-type contracts, the amounts reported shall reflect the best estimate of the annual requirement on the first reportable delivery order.

(5) Enter on line g. the cost of money percentage rate proposed by the contractor, obtained from block 1 of the CASB-CMF form. The objective and negotiated rate will be the cost of money percentage rate used on the DD Form 1861.

(o) *Item 14, Weighted Guidelines Profit Factors (see DD Form 1547).* If weighted guidelines are used, show the measurement base and profit/fee dollars in whole numbers in accordance with (n) above. If the weighted guidelines are not used to develop the prenegotiation profit objective, enter the measurement bases on line a. and complete only lines e., f., and g. The manufacturing guidelines adjustment, line a.(11), shall be completed only for contracts coded A in item 11 and must equal 30 percent of the amount entered on line a.(10). The cost of money adjustment, line e., shall be completed for all contracts coded as B, C, or D in item 11 and must equal the objective amount in item 13.b.

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DEPARTMENT OF DEFENSE FORMS

F-200.1499 *DD Form 1499: Report of Individual Contract Profit Plan*

REPORT OF INDIVIDUAL CONTRACT PROFIT PLAN						DOD COMPONENT	
1. REPORT NO.	2. BASIC PROCUREMENT INSTRUMENT IDENTIFICATION NO.				3. SPIIN	4. DATE OF ACTION	
	a. PURCHASING OFFICE	b. PY	c. TY-PROC-INST-CODE	d. PIIN		YEAR	MONTH
5. PURCHASING OFFICE NAME						ITEM 5 CODE	
6. TYPE OF PRICING ACTION A INITIAL AWARD B SUBSEQUENT NEGOTIATION OF COST/PROFIT						ITEM 6 CODE	
7. CONTRACTOR IDENTIFICATION	a. COMPANY NAME			b. DIVISION NAME (If any)		ITEM 7 CODE	
	c. STREET ADDRESS		d. CITY	e. STATE	f. ZIP CODE		
8. PRINCIPAL PLACE OF PERFORMANCE	a. CITY			b. STATE		ITEM 8 CODE CITY	STATE
9. FEDERAL SUPPLY CLASS OR SERVICE						ITEM 9 CODE	
10. DOD CLAIMANT PROGRAM						ITEM 10 CODE	
11. WEIGHTED GUIDELINES CATEGORY A MANUFACTURING B RESEARCH AND DEVELOPMENT C SERVICES D WEIGHTED GUIDELINES NOT USED						ITEM 11 CODE	
12. TYPE OF CONTRACT (*References DAR, Section III, Part 4*) A – FPR (*All types*) J – FFP K – FP (*E*) L – FPI (*All types*) R – CPAF U – CPFF V – CPIF (*All types*)						ITEM 12 CODE	
13. NEGOTIATION SUMMARY		CONTRACTOR		OBJECTIVE		NEGOTIATED	
a. SUBTOTAL COST							
b. COST OF MONEY (*DD Form 1861*)							
c. TOTAL COST							
d. PROFIT OR FEE							
e. TOTAL PRICE							
f. CEILING PRICE (*If applicable*)							
g. COST OF MONEY RATE (*DD Form 1861*)							
14. WEIGHTED GUIDELINES PROFIT FACTORS (*DD Form 1547*)				MEASUREMENT BASE		PROFIT/FEE DOLLARS	
a. CONTRACTOR EFFORT							
(1) MATERIAL ACQUISITION							
(2) ENGINEERING – DIRECT LABOR							
(3) ENGINEERING – OVERHEAD							
(4) MANUFACTURING – DIRECT LABOR							
(5) MANUFACTURING – OVERHEAD							
(6) SERVICES – DIRECT LABOR							
(7) SERVICES – OVERHEAD							
(8) OTHER COSTS							
(9) GENERAL MANAGEMENT – G & A							
(10) PROFIT/FEE SUBTOTAL							
(11) MANUFACTURING GUIDELINES ADJUSTMENT							
(12) TOTAL EFFORT							
b. CONTRACTOR COST RISK							
c. FACILITIES CAPITAL EMPLOYED							
d. SPECIAL PROFIT/FEE OBJECTIVE							
(1) PRODUCTIVITY							
(2) INDEPENDENT DEVELOPMENT							
(3) OTHER							
e. PROFIT/FEE SUBTOTAL							
f. COST OF MONEY ADJUSTMENT							
g. TOTAL PROFIT/FEE OBJECTIVE							
15. DATE SUBMITTED (*Yr, Mo, Day*)	16a. TYPED NAME OF CONTRACTING OFFICER OR REPRESENTATIVE (*Last, first, MI*)			16b. SIGNATURE OF CONTRACTING OFFICER OR REPRESENTATIVE		16c. TELEPHONE EXTENSION	

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F-200.1499

ARMED SERVICES PROCUREMENT REGULATION

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DEPARTMENT OF DEFENSE FORMS

F-200.1500 *Reserved.*

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DEPARTMENT OF DEFENSE FORMS

F-200.1547 *DD Form 1547: Weighted Guidelines Profit/Fee Objective*

WEIGHTED GUIDELINES PROFIT/FEE OBJECTIVE

1. CONTRACTOR IDENTIFICATION	a. COMPANY NAME				b. DIVISION NAME (If any)	
	c. STREET ADDRESS		d. CITY		e. STATE	f. ZIP CODE
2. WEIGHTED GUIDELINES CATEGORY (Check one) a. ☐ MANUFACTURING b. ☐ RESEARCH AND DEVELOPMENT c. ☐ SERVICES			3. TYPE OF CONTRACT (Ref DAR, Sec III, Part 4)			
4. BASIC PROCUREMENT INSTRUMENT IDENTIFICATION NO.						5. SPIIN
a. PURCHASING OFFICE	b. FY	c. TY-PROC-INST-CODE	d. PRISN			

6. WEIGHTED GUIDELINES PROFIT FACTORS (DAR 3-808.4)

PROFIT/FEE FACTOR OR SUBFACTOR (a)	MEASUREMENT BASE (b)	PROFIT WEIGHT RANGES MFG (%) (c)	R&D(%) (d)	SVCS(%) (e)	ASSIGNED WEIGHT (%) (f)	PROFIT/FEE DOLLARS (g)
PART I – CONTRACTOR EFFORT						
7. MATERIAL ACQUISITION						
a. SUBCONTRACTED ITEMS		1 TO 5	1 TO 5	1 TO 5		
b. PURCHASED PARTS		1 TO 4	1 TO 4	1 TO 4		
c. OTHER MATERIAL		1 TO 4	1 TO 4	1 TO 4		
8. ENGINEERING						
a. DIRECT LABOR		9 TO 15	9 TO 15			
b. OVERHEAD		6 TO 9	6 TO 9			
9. MANUFACTURING						
a. DIRECT LABOR		5 TO 9	5 TO 9			
b. OVERHEAD		4 TO 7	4 TO 7			
10. SERVICES						
a. DIRECT LABOR				8 TO 15		
b. OVERHEAD				4 TO 8		
11. OTHER COSTS						
12. GENERAL MGMT – G & A		6 TO 8	6 TO 8	6 TO 8		
13. SUBTOTAL PROFIT/FEE						
14. LESS: ADJUSTMENT FACTOR		30				
15. TOTAL EFFORT						
PART II – CONTRACTOR RISK						
16. COST RISK	(Total from Col b)	0 TO 8	0 TO 7	0 TO 4		
PART III – FACILITIES INVESTMENT						
17. CAPITAL EMPLOYED	(Line 8, DD Form 1861)	15 TO 20				
18. BASIC PROFIT/FEE OBJECTIVE (Items 14 + 15 + 17, Col g)						
PART IV – SPECIAL FACTORS						
19. SPECIAL PROFIT/FEE OBJ						
a. PRODUCTIVITY	(See DAR 3-808.8(a))					
b. INDEPENDENT DEVELOPMENT	(See DAR 3-808.8(b))	1 TO 4	1 TO 4			
c. OTHER	(Total from Item 16)	-8 TO +8	-8 TO +8	-8 TO +8		
d. TOTAL SPECIAL PROFIT/FEE OBJECTIVE						
20. SUBTOTAL PROFIT/FEE OBJECTIVE (Items 18 + 19d, col g)						
PART V – COST OF MONEY OFFSET (Applicable to Research and Development and Services Weighted Guidelines only.)						
21. LESS: FACILITIES CAPITAL COST OF MONEY (DAR 3-808.8(c)(1)(ii))						
22. TOTAL PROFIT/FEE OBJECTIVE (Items 20 – 21, col g)						

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F-200.1564 *DD Form 1564: Pre-Award Patent Rights Documentation*

PRE-AWARD PATENT RIGHTS DOCUMENTATION			FORM APPROVED OMB NO. 22-R262
PROCUREMENT IDENTIFICATION			
CONTRACTOR IDENTIFICATION (TO BE COMPLETED BY OFFEROR)			
a. COMPANY NAME			
b. DIVISION NAME (If any)	c. ADDRESS (Number and Street, City, State, Zip Code or Country)		
CHECK APPLICABLE BLOCK		YES	NO
2. IS THE OFFEROR INTERESTED AT THIS TIME IN ACQUIRING PRINCIPAL OR EXCLUSIVE RIGHTS TO INVENTIONS MADE UNDER ANY RESULTING CONTRACT? IF ANSWER IS "YES", REMAINING QUESTIONS SHALL BE ANSWERED. IF ANSWER IS "NO" REMAINING QUESTIONS NEED NOT BE ANSWERED AND THE PATENT RIGHTS DEFERRED CLAUSE OF ASPR 7-302.23(c) OR 7-302.23(i) WILL BE APPLICABLE.			
3. IS OFFEROR REGULARLY ENGAGED AS A MANUFACTURER OR SOURCE OF PRODUCTS OR SERVICES DIRECTLY RELATED TO A FIELD OF TECHNOLOGY INVOLVED IN THIS PROCUREMENT TO THE GENERAL DOMESTIC PUBLIC OR TO FOREIGN GOVERNMENTS, NATIONALS OR BUSINESS; OR TO MULTI-NATIONAL ORGANIZATIONS? *(See ASPR 9-107.3(b)(3)(i))*			
4. HAS OFFEROR WITHIN THE IMMEDIATE PAST FIVE YEARS DEVELOPED NONGOVERNMENTAL MARKETS FOR INVENTIONS DIRECTLY RELATED TO A FIELD OF TECHNOLOGY INVOLVED IN THIS PROCUREMENT? *(See ASPR 9-107.3(b)(3)(ii))*			
5. IF ANSWER TO 3 AND OR 4 IS "YES", INDICATE WHETHER THE PRODUCTS, SERVICES OR INVENTIONS ARE FOR SALE OR LEASE TO:			
a. U.S. GENERAL PUBLIC			
b. FOREIGN GOVERNMENTS			
c. FOREIGN NATIONALS OR BUSINESSES			
d. MULTI-NATIONAL ORGANIZATIONS			
6. IF ANSWER TO 3 AND OR 4 IS "YES", IDENTIFY REPRESENTATIVE PRODUCTS, SERVICES, OR INVENTIONS AND THEIR ASSOCIATED MARKETS.			
7a. DOES OFFEROR HAVE AN EFFECTIVE PROGRAM FOR THE TRANSFER OF TECHNOLOGY AS BY LICENSING OF INVENTIONS DIRECTLY RELATED TO A FIELD OF TECHNOLOGY INVOLVED IN THIS PROCUREMENT. *(See ASPR 9-107.3(b)(3)(iii))*			
b. IF ANSWER TO 7a IS "YES", IDENTIFY REPRESENTATIVE LICENSES BY LICENSEE, TECHNOLOGY, DOMESTIC OR FOREIGN MARKETS TO WHICH TECHNOLOGY TRANSFERRED, AND PATENT NUMBERS, AS APPROPRIATE.			
TYPED NAME AND TITLE	SIGNATURE OF PERSON COMPLETING THIS FORM	DATE SIGNED	

DD FORM 1 OCT 76 1564 EDITION OF 1 JUNE 66 IS OBSOLETE

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Senator MORGAN. It is understood that the Office of Federal Procurement Policy has issued for comment a profit policy for defense contracts—the thrust of which would permit competitors to earn from such contracts the same as they could earn from the investment in other opportunities with a similar risk? Is this correct?

Mr. CHURCH. The proposed policy you refer to would be applicable to all Federal agencies, and contains a broad statement of policy referring to long-term profits on Government contracts generally. It should not be taken to apply to individual contracts. We are recommending to the Office of Federal Procurement Policy that this statement be changed to clarify this point.

Senator MORGAN. Could there not be examples where the provisions of this bill, if enacted, would cause a reduction in overall profits for any given defense contractor?

Mr. CHURCH. Any profit limitation statute, if invoked to recoup excess profits, would cause a reduction in overall profits for a defense contractor. The Patterson bill has a loss carry forward feature, however, which would allow a net loss in a given year to be allowed as a credit against any excess profit for the next 4 years.

Senator MORGAN. For example, we have heard that profits in the shipbuilding industry for constructing naval ships has been on the order of 2 percent to 3 percent after taxes in the past few years. At the same time, there may be examples under a particular contract for overhaul or otherwise where the fee or profit might exceed 15 percent. Since this bill does not limit profits by contract and does not permit any aggregation, would not the result under such circumstances be a reduction where the profit on new construction might be 5 percent but also limited to 15 percent for other work?

Mr. CHURCH. Yes.

Senator MORGAN. In terms of application, how would DOD apply the excess profits limitation to contracts involving in part foreign production—such as, for instance, the various co-production contracts which will be amended and added to from time to time with producers in NATO countries for the F–16?

Would DOD also apply these provisions to all contracts involving foreign military assistance?

Would it also apply to DOD contracts with overseas producers in other countries, that is with non-U.S. corporations?

Mr. CHURCH. We interpret the language of the Patterson bill as exempting contracts for foreign military sales, which are paid for by a foreign country, but applying to purchases made under the military assistance program, which are paid for with appropriated funds.

The bill would technically apply to such contracts, although as a practical matter, we would likely waive the application of profit limitation in these cases.

Senator MORGAN. Even though the terms of the bill would apply to any negotiated DOD contracts, how could it be applied to a foreign corporation where the problems of auditing and policing not controlled by U.S. law might be most difficult?

Mr. CHURCH. In our dealings with foreign corporations, we have sought to do business with them on the same terms as we would with a U.S. contractor. We believe such an approach is in the best interest of the American taxpayer. We have been generally successful in this business approach, once the ground rules are understood by the foreign contractor. We do not anticipate any real problems in this regard.

Senator MORGAN. We will stand adjourned.

[Whereupon, at 4:15 p.m. the subcommittee meeting was adjourned.]

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VINSON-TRAMMELL ACT REPEAL OR REVISION

WEDNESDAY, APRIL 2, 1980

U.S. SENATE,
PROCUREMENT POLICY AND REPROGRAMING SUBCOMMITTEE,
COMMITTEE ON ARMED SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:05 p.m., in room 212, Russell Senate Office Building, Hon. Robert Morgan presiding.

Present: Senator Morgan.

Staff present: John C. Roberts, general counsel; Rhett B. Dawson, counsel; John T. Ticer, chief clerk; Karen A. Love, clerical assistant.

OPENING STATEMENT BY SENATOR MORGAN, CHAIRMAN

Senator MORGAN. We will reconvene our committee meeting.

On February 25 of this year, we held our first hearing on the subject of the Vinson-Trammell Act. At that time, we took testimony from Senators Cranston of California and Lugar of Indiana who have introduced a bill here in the Senate, S. 1687, to repeal the Vinson-Trammell Act. This bill is substantially identical to one introduced by Representative McCloskey of California in the House. Congressman McCloskey will testify here today to explain his bill and to give support for it.

On February 25, we also heard testimony from Senator Pell of Rhode Island in support of his bill which raises the exemption figure in the Vinson-Trammell Act as currently written.

We also heard from Senator Mathias of Maryland who testified in support of repeal of the Vinson-Trammell Act, and from Congressman Patterson of California who testified in support of his bill which would repeal the existing act and put in its place a 15-percent profit limitation on sole source contracts in excess of $5 million let by the Defense Department.

He would permit deductions for value engineering and incentive amounts earned by the contractor under the terms of the contracts. In the event of net loss situations on defense contracts he would permit a 4-year carryover.

His legislation would have a 5-year sunset date and provide for annual reports to the Congress.

After the hearing on February 25, 1980, I introduced here in the Senate a bill identical to that introduced into the House by Congressman Patterson, not because I necessarily espouse all of its provisions, but because I view it as a viable alternative which we should have officially before the subcommittee.

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In addition to hearing from Congressman McCloskey today in support of his bill to repeal Vinson-Trammell, we will hear from Congressman Joseph Minish of New Jersey, who is the sponsor of a bill in the House, H.R. 3623, which would essentially revamp Vinson-Trammell as a successor to the Renegotiation Act, setting a straight 10-percent profit limitation on all defense work, including subcontracts above a $3 million threshold and providing a number of factors for the Secretary of the Treasury to consider when determining whether profits in excess of 10 percent are unreasonably high.

We will also hear from Mr. Walton H. Sheley, of the General Accounting Office, who will give the views of that agency on the Vinson-Trammell Act and any potential successor profit limitation which may be proposed.

We will also take testimony today from Theodore M. Kostos representing the American Bar Association, Mr. William H. Smith, corporate director of contracts, Newport News Shipbuilding & Drydock Co., Mr. Carl A. Paladino, senior vice president and treasurer, Grumman Aerospace Corp., and Mr. John W. Zevenbergen, president and chief operating officer, John Fluke Manufacturing Co., Inc.

We welcome you, Congressman Minish. We would be glad to hear from you at this time.

STATEMENT OF HON. JOSEPH G. MINISH, A U.S. REPRESENTATIVE FROM THE STATE OF NEW JERSEY, ACCOMPANIED BY JIM BROWN, COUNSEL

Representative MINISH. Thank you, Mr. Chairman. Thank you for inviting me to testify on the subject of the Vinson-Trammell Act.

My message is rather simple. First, I would like to tell you why we need an agency to watch over and prevent excessive profits on the part of defense contractors. Then I would like to explain what I think such an agency should look like.

I ask, Mr. Chairman, that the full text of my speech be put in the record.

Senator MORGAN. The full text of your statement will be made a part of the record.

[The prepared statement of Mr. Minish follows:]

PREPARED STATEMENT OF CONGRESSMAN JOSEPH G. MINISH

Mr. Chairman, members of the subcommittee, thank you for inviting me to testify on the subject of the Vinson-Trammell Act.

My message is rather simple. First, I would like to tell you why we need an agency to watch over and prevent excessive profits on the part of defense contractors. Then I would like to explain what I think such an agency should look like.

As we all know, President Carter has proposed substantial increases in our military budget. I don't have to tell the members of the Senate Armed Services Committee that we already spend an enormous amount of money on defense procurement. According to the Department of Defense, we spent over $65 billion on procurement in 1978. This was an increase of almost $10 billion over the 1977 figure.

Given this substantial increase and the likelihood that our military spending will continue to rise sharply, I think the American people have a right to expect that their money is spent wisely and not thrown away.

I think most people would agree that there are two ways to insure reasonable prices and profits for the defense industry. One would be to leave the question

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of price to the market place. I believe that in a healthy and truly competitive market we could rely on price competition to ensure that we get the best bargains for our dollars. However, according to the Department of Defense, only a fraction of defense contracts, usually less than 15 percent, are awarded on the basis of price competition. In 1978, 63.8 percent—almost two thirds of all defense procurement went to sole sources. The percentage of sole source awards has risen and will apparently continue to rise every year. In 1976, 57 percent of our procurement dollars went to sole sources. In 1977, that amount rose to 62.4 percent and, as I said, in 1978 it rose again to 63.8 percent. In addition to the large sole source awards, most of the remaining government contracts are given out in situations where there are only a few competitors and where, because of technical, engineering or other factors, there may be little or no competitive pressure to keep prices and profits at a reasonable level. Therefore, in many segments of the defense industry, the government faces a seller's market where contractors set prices. Because government demand reflects public policy choices rather than market pressure, the government often finds itself in a situation where it needs hardware and must pay whatever the contractor asks. In such cases, the only way the government can protect itself is to review contracts after they are completed and to recover any excessive profits at that time.

The defense industry and its supporters will attack any form of profit limitation by contending that our defense procurement system has built-in safeguards which can prevent excessive profits. In many cases, that's not true. No government procurement safeguard or refinement places a limit on how much money the government will have to pay a sole source defense contractor if the contractor names his price and refuses to proceed with the work until his demands are met. In a seller' market, the DOD has little leverage to negotiate lower prices and no existing DOD procurement safeguard gives it the authority to do so.

It is worth noting, but seldom mentioned, that practically every independent study of our procurement system has recommended post-contract curbs on excessive profit. Among those studies are:

1. Report by the Staff of the Joint Committee on Internal Revenue Taxation—September 30, 1975.
2. GAO Report—"The Operations and Activities of the Renegotiation Board"—May 9, 1973.
3. GAO Report—"Causes of Excessive Profits on Defense and Space Contracts"—December 31, 1975.
4. Report of the Commission on Government Procurement—December, 1972.
5. Report by the Committee on Government Operations—"The Efficiency and Effectiveness of Renegotiation Board Operations"—December 16, 1971.

On the other hand, there have been no independent studies which have recommended abolishing all procurement watchdog agencies. In fact, the only studies I have ever seen which recommend abolishing watchdog agencies have been done under the auspices of the defense industry. To say the least, I question the objectivity of studies supported by those with such an enormous vested interest.

I feel that I should also mention that while the spokesmen for the defense industry cite procurement safeguards as obviating the need for watchdog agencies, these same industry representatives are doing their best to eliminate those safeguards. For example, the defense industry right now is in the midst of a concerted effort to kill one of the procurement safeguards they cite—the Cost Accounting Standards Board. If you don't believe me, ask some of the defense lobbyists about their views on the Cost Accounting Board when they testify here.

In summation, if we had true price competition in the defense industry, I would say that we don't need a watchdog agency. However, with two-thirds of our defense dollars going to sole sources, there has to be some other way of insuring that the taxpayers we represent get true value for the enormous amount of money we spend for defense. The only way to do this is to have an independent agency looking over the shoulder of the DOD and the defense industry.

I would like to make a few suggestions about what this watchdog agency should look like.

Not surprisingly, I am not thrilled with the Vinson-Trammell Act in its present incarnation. It is unfair in that it applies only ot a small portion of defense contractors and that it places an unreasonable burden upon small businessmen. I do believe that Vinson-Trammell can be amended to make it a fair and useful check on profiteering by defense contractors.

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I think that an equitable and up-to-date Vinson-Trammell Act must contain the following elements.

1. *It should be independent.*—The administration of the Vinson-Trammell Act should stay right where it is now, with the IRS. Several people have suggested transferring Vinson-Trammell to the Department of Defense. I think that this would amount to putting the fox in charge of the chicken coop. The job of the Department of Defense is to buy and use military hardware. Every time a dollar of excess profits is found in a defense contract, this reflects upon the DOD procurement system. If the DOD is put in charge of overseeing its own operations, there will be enormous pressure upon the administrators of Vinson-Trammell to overlook rather than oversee excessively high profits. Our government is based on a system of checks and balances that has worked reasonably well for 200 years. I believe that if we are serious about preventing excessive profits, we will place an independent check on them in the form of a watchdog agency outside DOD.

2. *It should apply to all defense contracts.*—As you know, Vinson-Trammell currently applies only to the manufacture of naval vessels and aircraft. Singling out these two industries is inequitable and unwise. There is no logical reason for distinguishing between excessive profits on airplanes as opposed to tanks or guns. The law as presently written insures endless arguments, for example, about whether or not a missile is an aircraft. In the interest of fairness, Vinson-Trammell should apply to all large defense contractors.

3. *It should have flexible standards which can take into account the differences among various defense industries.*—For example, I think that a company which provides high-technology, state-of-the-art weapons to the Air Force should not be given the same treatment as a company that supplies soap to the Navy. Therefore, I think there should be a maximum profit percentage which will function as a guideline for contractors and the federal government. Flexibility for higher profits should be permitted. Among the things that should be considered in deciding what constitutes a reasonable profit are, profits as a percentage of capital investment and net worth, that is, whether the contractor has a lot of his own money invested in his business; the risk the contractor takes, for example, whether he is producing experimental products; the contractor's efficiency; and various other consideration.

I would emphasize that any restriction on excessive profits is not intended as a tax. Its primary purpose is preventing profiteering and any revenue that it raises for the government is secondary. Thus, I don't believe it is essential or wise to have a mechanical, unbending method of computing what constitutes a reasonable profit. A flexible statute, which takes into consideration the differences among defense contractors is the best way to go.

4. *Reporting and computation of profits under Vinson-Trammell should be on an aggregate fiscal year basis.*—At present, the Vinson-Trammell Act requires reporting on a contract-by-contract basis. I believe that reporting on a fiscal year basis would be more attuned to contractors' bookkeeping systems, and, therefore, would minimize their paperwork burden. Under the ideal Vinson-Trammell Act, contractors would merely have to segregate their government business from their nongovernment business and then report their costs, profits and losses on the government part. I think this would be the least burdensome method of keeping track of excessive profits.

5. *There should be a floor in the statute to protect small businessmen.*—The great majority of defense business goes to a relatively small number of corporations. Two-thirds of procurement money goes to the DOD top 100. The most efficient use of our resources would be to focus on the large contractors rather than the small ones. In addition, our government has had a longstanding policy of encouraging and assisting small businessmen. Exempting them from coverage under Vinson-Trammell would help them to compete more effectively with the large contractors. I think that a good place to draw the line between large and small would be at $3 million per year in aggregate government sales.

6. *The watchdog agency should function in peacetime as well as in wartime.*—As you know, various individuals have suggested that we should try to prevent excessive profits only in time of war. That is a bogus argument if I've ever heard one. The theory behind having a watchdog agency in wartime is that during war, government demand increases so sharply that the procurement system cannot keep up with it and profiteering can take place. While this is true on its face, it is equally true that government demand has experienced sharp increases

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during periods when we were not technically at war. I needn't remind you that we spent a huge amount of money in the late 1960's and early 1970's although there was no declared war. We are embarking on another period of huge increases in military demand, but hopefully, we will not go to war. The fact is that our projected increases in defense spending make a watchdog agency for excessive profits absolutely necessary right now. We spent more in 1978 for military procurement than we did in 1967 or 1968, the peak Vietnam war years. As our demand increases further and competition within the defense industry decreases, it becomes more and more important to institute an independent check on excessive profits. Talking about "wartime" and "peacetime" in our present international situation makes no sense.

In conclusion, I think that the six elements I have described are the basics for a good Vinson-Trammell Act. As you may have guessed by now, the bill which I have introduced in the House, H.R. 3623, contains these six elements. I hope that you will examine it closely as you deliberate on the future of our procurement system.

Thank you.

Representative MINISH. Thank you, Mr. Chairman.

Given the substantial proposed increase in the military budget and the likelihood that our military spending will continue to rise sharply, I think the American people have a right to expect that their money is spent wisely and not thrown away. There are two ways to insure reasonable prices and profits for the defense industry.

One would be to leave the question of price to the marketplace. I believe in a healthy and truly competitive market; we could rely on price competition to insure we get the best bargains for our dollars. However, according to the Department of Defense, only a fraction of defense contracts, usually less than 15 percent, are awarded on the basis of price competition.

In 1978, 63.8 percent, almost two-thirds of all defense procurement, went to sole sources. In many segments of the industry the Government faces a seller's market where contractors set prices, because Government demand reflects public policy choices rather than market pressures. The Government often finds itself in a situation where it needs hardware and must pay whatever the contractor asks.

The defense industry and its supporters will attack any form of profit limitation by contending that our defense procurement system has built-in safeguards which can prevent excessive profits. In many cases, that is not true. No Government procurement safeguard or refinement places a limit on how much money the Government will have to pay a sole source defense contractor, if the contractor names his price and refuses to proceed with the work until his demands are met. In a seller's market, DOD has little leverage to negotiate lower prices, and no existing DOD procurement safeguard gives it the authority to do so.

It is worth noting that practically every independent study of our procurement system has recommended post-contract curbs on excessive profits. On the other hand, there have been no independent studies which have recommended abolishing all procurement watchdog agencies. In fact, the only studies I have ever seen which recommend abolishing watchdog agencies have been done under the auspices of the defense industry.

If we had true price competition in the defense industry, I would say we did not need a watchdog agency. However, with two-thirds of our

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defense dollars going to sole sources, there must be some other way of insuring that the taxpayers we represent get true value for the enormous amount of money we spend for defense.

The only way to do this is to have an independent agency look over the shoulder of the DOD and the defense industry. Not surprisingly, I am not thrilled with the Vinson-Trammell Act in its present form. I do believe that Vinson-Trammell can be amended to make it a fair and useful check on profiteering by defense contractors. I think an equitable up-to-date Vinson-Trammell Act must contain the following elements.

One: It should be independent. The administration of the Vinson-Trammell Act should stay where it is now in the IRS. Several people have suggested transferring Vinson-Trammell to the Department of Defense. I think this would amount to putting a fox in charge of the chicken coop.

If we are serious about preventing excess profits, we will place an independent check on them in the form of a watchdog agency outside the DOD.

Two: It should apply to all defense contracts. As you know, Vinson-Trammell currently applies only to the manufacture of naval vessels and aircraft. Singling out these two industries is inequitable and unwise. There is no logical reason for distinguishing between excessive profits on airplanes as opposed to tanks or guns.

Three: It should have flexible standards which could take into account the differences among the various defense industries. For example, I think a company which provides high-technology, state-of-the-art weapons to the Air Force should not be given the same treatment as a company that supplies soap to the Navy. Therefore, I think there should be a maximum profit percentage which functions as a guideline for contractors and the Federal Government. Flexibility for higher profit should be permitted.

Four: Reporting and computation of profits under Vinson-Trammell should be on an aggregate fiscal year basis. At present, the Vinson-Trammell Act requires reporting on a contract by contract basis. I believe that reporting on a fiscal year basis would be more attuned to contractors' bookkeeping systems, and therefore would minimize their paperwork burden.

Five: There should be a floor in the statute to protect small businessmen. The great majority of defense business goes to a relatively small number of corporations. Two-thirds of our procurement money goes to the DOD top 100. The most efficient use of our resources would be to focus on the large contractors rather than small ones. I think a good place to draw the line between large and small would be at $3 million per year in aggregate Government sales.

Six: The watchdog agency should function in peacetime as well as in wartime. As you know, Mr. Chairman, various individuals have suggested that we should try to prevent excessive profits only in time of war. That is a bogus argument if I have ever heard one. I need not remind you we spent a huge amount of money in the late sixties and early seventies, although there was no declared war.

We are embarking on another period of huge increases in military demand, but hopefully we will not go to war.

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In conclusion, Mr. Chairman, I think the six elements I have described are the basics for a good Vinson-Trammell Act. As you may have guessed by now, the bill which I have introduced in the House, H.R. 3623, contains six elements.

I want to thank you, Mr. Chairman, and I would be happy to try to answer any questions you might have on your mind.

Senator MORGAN. Congressman, I know you are operating under a time constraint, but your statement was very succinct, and your six points, I think, are very well stated. Let me ask you this question. It bothers me at the present time.

As I understand it, when the Renegotiation Board was abolished, the Vinson-Trammell Act came into effect.

Representative MINISH. That is my understanding.

Senator MORGAN. My recollection is, that would make the Vinson-Trammell Act effective in September of 1976.

Representative MINISH. September 30, 1976.

Senator MORGAN. Right. As I also understand it, neither IRS nor DOD have guidelines or regulations for the carrying out of this act. Is that correct?

Representative MINISH. [Nods affirmatively.]

Senator MORGAN. It bothers me that we have gone now from September 1976 to the present without regulations for administering the act, and I am told, although I have not verified this, that some audit firms are now footnoting their statements in contingent liability, et cetera.

What do you think we should do about contracts entered into since September 1976, until such time as we either modify, repeal, or amend this act?

Should we suspend its operation during this period when there are no regulations? What are your thoughts on that?

Representative MINISH. No, Mr. Chairman, I would not be for suspending anything. I think that many defense contractors did very well when the Renegotiation Act was eliminated. I recall that about $150 billion worth of Government contracts were just swept under the rug, and no one had a chance to look at them.

Now, no one knows how much in excessive profits was ignored, but I certainly think the taxpayers would have received some return from those contracts, and because of that, I see no reason why we should give them further exemptions from compliance.

Senator MORGAN. The thing that bothers me is, if we don't have any regulations, it seems what we are saying is, all we expect for the Government is a fair advantage. We have a law. The Government is charged with the responsibility of administering it. They have not done it.

The thought occurs to me that this is going to be a very important piece of legislation regardless.

Representative MINISH. There is no question about that, Mr. Chairman.

Senator MORGAN. I quite candidly doubt that we would be able to handle it this year. I have not seen much movement in the House, and it is now April. July is the Republican Convention. August is the Democratic Convention and the elections. I am thinking of some kind of stopgap measure.

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Representative MINISH. Well, the IRS issued preliminary regulations, not final ones, so I am not in a position to tell you what they are going to do at this time.

Senator MORGAN. Those are some of my thoughts. We appreciate your coming over very much.

Representative MINISH. Thank you very much, Mr. Chairman, for having me.

Senator MORGAN. We will be in touch. Your staff and the staff of the committee, I am sure, will be working together.

Mr. Zevenbergen, you may proceed and also identify the person accompanying you at the table for the record.

STATEMENT OF JOHN W. ZEVENBERGEN, PRESIDENT, JOHN FLUKE MANUFACTURING CO., INC., ACCOMPANIED BY WILLIAM F. BARRETT

Mr. ZEVENBERGEN. Yes, thank you, Mr. Chairman.

My name is John Zevenbergen, and I am president and chief operating officer of the John Fluke Manufacturing Co., Inc., located in Seattle, Wash., and I have with me William Barrett, manager, contract and pricing policy, from our company.

I am here on behalf of Fluke Co's officers and directors. I appreciate this opportunity to appear before you to discuss the Vinson-Trammell Act and the impact its implementation would have on my company. However, before addressing those issues, I believe a brief discussion of the Fluke Co., how it started, what it produces, and the factors that contributed to its growth, will be helpful to an understanding of our concern.

The John Fluke Co. was founded in 1948 as a sole proprietorship operating out of the basement of the founder's home in Springdale, Conn. It had the same purpose then that it has today: Engineering, manufacturing, and marketing commercial, off-the-shelf electronic test and measuring equipment.

While our 1948 products were crude by today's standards, they contributed distinctly to the science of precision measurements and we believe our present day products continue that tradition. In 1952, we moved to the Seattle, Wash., area and substantial growth occurred, generated from within by the sales of proprietary products in the competitive marketplace.

Public offerings of stock were made in 1959 and 1962, paving the way for a growth pattern based on new products brought to market through continuous innovation in design, modern cost-effective manufacturing techniques, and a sound marketing structure.

While most of our sales are derived strictly from the commercial marketplace, many Government applications require test equipment with capabilities identical to those required by industry. So our customer base also includes civilian and military agencies. Typically we sell capital equipment to Government research and calibration laboratories. We also sell bench and field test equipment for general purpose weapons systems, as well as industrial-type measuring devices for pollution control, process monitoring, and other applications closely

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alined with industry. No Fluke produce has ever been developed solely for the Government or at Government expense.

We have been able to successfully compete in the marketplace, generally producing sufficient profit from the operation to satisfactorily finance growth of the company. We have never paid our stockholders a cent in dividends to date. They seem to be content to see the profit used for growth. We participate in an industry that is intensely competitive, and we believe that this intense competition contributes directly to the dramatic advances we all have witnessed over recent years in electronic technology. In our industry, failure to compete on at least three fronts is tantamount to going out of business.

First: We must compete in a seriously depleted labor market for qualified personnel dedicated to the overall corporate objectives. Second: We must compete in the development and production of items noted for their technical excellent. Third: We must produce in a cost-effective manner, without degrading quality or performance, in order to compete in price and at the same time make a profit. Throughout all this, we must meet the challenge of a constantly expanding state of the art, and in many cases contribute to its expansion.

The effectiveness of the company's participation in this dynamic environment is epitomized by its growth pattern. In 1969, the company's consolidated sales were $10.6 million. In 1979, the company's consolidated sales were $104.2 million. That calculates to a 10-year 25.7 percent annual growth rate in an industry noted for providing more product for less dollars, in spite of inflation, than any other industry in the United States.

From September 1977, to the present, our employee population has grown from 1,500 to over 2,700 people. Our rate of growth is the equivalent of producing another company our present size almost every 3 years.

Now what has all this to do with the Vinson-Trammell Act? Most of us already are aware of the background of the act, and simply summarized, its passage occurred in an era when adequate safeguards and controls in the procurement process were nonexistent. That it remains an active statute today is the result of a legislative oversight. Congress, in its own wisdom, determined that such after the fact limits on defense industry profits were unnecessary when it allowed the renegotiation board to finally cease operation last year.

We believe that the defense procurement safeguards enacted subsequent to 1951 were accepted by you and your colleagues in the Congress as more than adequate to insure that defense contractors perform their obligations in a manner satisfactory to the taxpayers, the buying agencies, and the defense mission; and at the same time at the lowest possible cost in a free economy.

Among these safeguards are: The Truth in Negotiation Act; the Right to Audit Act; the Cost Accounting Standards Act; the establishment of the Defense Contract Audit Agency with resident offices in most major defense contractor plants; the Defense Contract Administration Service, and additional controls the complex of which encompasses, according to a November 1979, GAO report, "many of the 80,000 Federal employees engaged in procurement related work. . . ." As taxpayers, ourselves, we applaud your vision in that regard. How-

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ever, also as taxpayers, as well as partners in the defense mission, we feel it is not only our right but our duty to counsel against the implementation of obsolete, unneeded, nonproductive, burdensome legislation.

In our opinion, the Vinson-Trammell Act meets all of the above questionable qualifications. To allow its implementation would be to deny all congressional foresight, experience, intelligence, and knowledge-in-application of the "free enterprise" system over the past 46 years.

By way of example, I draw your attention to the Truth in Negotiation Act. When the 87th Congress enacted that statute in 1962, it recognized that the competitive, commercial marketplace was a far more demanding master in the establishment of "reasonable" price than any government body could be. The act provides that truly competitive procurements, and/or procurements in which a contractor can meet the qualifications of a commercial catalog price may be exempted from the requirement to furnish cost or pricing data.

In this environment, a contractor is free to make whatever profit he can. By the same token, he also assumes all risk of loss. The act also recognizes that there is a point at which it becomes economically unfeasible to both the contractor and the government to prepare and evaluate cost or pricing data. This has generally been determined to occur at the $100,000 level for a single procurement. Similar provisions became part of the Cost Accounting Standards Act when it was enacted by the 90th Congress in 1968.

The Vinson-Trammell Act makes no such distinctions. It applies to every procurement over $10,000, even to the lowest level of subcontract, regardless of whether true competition existed or whether the item is a bona fide catalog product. Vinson-Trammell also ignores the punitive cost impact of forcing commercial suppliers into establishing additional unnecessary accounting systems.

Webster defines "free enterprise" as "freedom of private business to organize and operate for profit in a competitive system without interference by Government beyond regulation necessary to protect public interest and keep the national economy in balance."

We believe our previously cited track record qualifies us as being reasonably expert in the operation of the competitive system. We have determined that in our business in order to finance its growth, which we generally hope continues, we must produce about an 8.5-percent after tax return on sales. This equates to almost 16 percent before taxes.

Depending on whether you use the DOD or the IRS interpretation of profit, Vinson-Trammell would provide us with anywhere from a 2.7-percent to a 5.6-percent after tax profit. At the same time, the act would impose on us another layer of regulation which would require additional people dedicated to preparing totally unproductive reports and thereby increasing our costs of doing business. Which costs, I might add, after they have been substantially amplified by the costs of the Government review process will ultimately be paid by the taxpayers.

DOD itself has calculated that the act would require some 500,000—and that estimate is probably low—reports be filed annually at a cost to industry in excess of $80 million.

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Do you think the passthrough of this needless cost to the taxpayers is, as Webster put it, protecting "the public interest," or keeping "the national economy in balance?" We certainly don't think so.

In testifying before the Senate Committee on Banking, Housing, and Urban Affairs on June 17, 1977, concerning the continuance of the Renegotiation Act, Mr. John Fluke, Sr., chairman of the board and chief executive officer of the Fluke Co., said:

> Now, as chief executive officer of this company, my managers and I must look at the cost of renegotiation, its redundancy, an dthe possibility of it being made even worse. We then have to ask ourselves some sobering questions. Can we afford to sell to the Federal Government? How much low profit, high-regulation Government business can we offset against our more adequately profitable commercial business and still maintain the stability of our own work force? How much can we ask the commercial customer to subsidize our Government business and still remain competitive? Will our competition opt for less Government business and beat us in the commercial marketplace?

I might mention overall our Government business is probably one-third to one-half as profitable as other business we bring into the company.

Gentlemen, the officers and managers of John Fluke Manufacturing Co., Inc., have taken a similar look at the costs and the risks of Vinson-Trammell covered business, and frankly, we can't afford it. As a matter of fact, we are even now seriously considering declining acceptance of such business. In the event the Vinson-Trammell Act is fully implemented, we most assuredly will refuse such sales. We also believe that increasing numbers of quality commercial suppliers will come to the same conclusion, if indeed they have not already.

We believe that failure to repeal this legislative leftover from antiquity has the very real potential to seriously erode the Nation's industrial mobilization base. On behalf of the entire Fluke Co., I strongly urge your recommendation to the Congress and the administration for repeal of the Vinson-Trammell Act.

Thank you for your kind attention. I will be pleased to answer any questions you have.

Senator MORGAN. Thank you very much for your statement.

I notice in your statement that you say that none of your products have ever been developed solely for the Government or with any Government assistance.

Mr. ZEVENBERGEN. That is correct.

Senator MORGAN. So most of your dealings with the Government are in the true competitive marketplace.

Mr. ZEVENBERGEN. Yes, sir.

Senator MORGAN. I can understand your position there, but let me show you—I just happened to pick up this Time magazine on the way over here. It is a $4 billion contract to Boeing for the cruise missile, which is not an off-the-shelf product. It is really a sole source proposition.

Do you see any need of any kind of protection to the public for exorbitant or unreasonable profits in the biggest contract which has been let since the Korean war, as I understand it?

Mr. ZEVENBERGEN. I think you have sufficient protection under the legislation already in place. That should be sufficient to protect against an exorbitant profit in a contract like that.

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Senator MORGAN. I noticed you named a number of them, the Truth in Negotiations Act and so on, but aren't both sides in a situation like this dealing with a certain number of unknowns which no one can predict or foresee?

Mr. ZEVENBERGEN. Development of technology is certainly always a risky process, but I have to speak basically from my knowledge, obviously, of our company's history in dealing with the Government, and of course very little of this legislation makes any distinction between a commercial, off-the-shelf house and a contract such as that.

Senator MORGAN. Well, it doesn't, but it seems to me if you are dealing off-the-shelf, you are dealing at arm's length and you are dealing more in a competitive environment. The question which concerns me is, do you feel that the public is entitled to any kind of after profits protection? I do not know how long this contract is going to run, but over a period of years, when you are dealing with so many unknowns, and are not dealing in a competitive environment.

Now, I might say I voted for the repeal of the Renegotiation Act. I didn't know of the Vinson-Trammell Act at the time, and I suspect a lot of others did not know, either.

Mr. ZEVENBERGEN. I guess the question comes back to the fact that while the Renegotiation Act was in effect, did it actually result in saving the taxpayer a lot of money, or did it end up costing him a lot of money? From my knowledge of it, there was considerable cost to the taxpayer.

Senator MORGAN. I grant you that is true. I am not arguing the case for it, but there are those who contend that it was the way it was administered. Since you deal primarily with subcontracts and you do deal in off-the-shelf items, what would be the special problems of smaller firms such as yours in dealing with the Vinson-Trammell Act?

Mr. ZEVENBERGEN. The real problem is, I guess, the fact that it covers any particular purchase order over $10,000 on a job basis. We have a standard cost accounting system at Fluke, and we would have to set up an entirely different way of keeping the books if we were going to look at every purchase order that might be involved in Vinson-Trammell above the $10,000 level.

Senator MORGAN. What would you think if the committee and Congress should feel that some kind of protection should be provided for in raising the threshold? I believe Senator Pell advocated raising it to $1 million. Congressman Patterson $5 million, and perhaps someone else $3 million. What if the threshold were raised to $5 million?

Mr. ZEVENBERGEN. The problem is, once you have a law like that on the books, they can keep playing with these limits. Again, speaking for the Fluke Co., the Government knows right now exactly what the situation is at Fluke, so far as what profit it makes. I certainly do not feel we need any more headaches than we have today in trying to satisfy the Government insofar as the profit on any of the business we do with them.

Senator MORGAN. I understand your point of view. You develop any products you make with your own money and resources. You put it on the shelf and sell it to other people, but the problem which bothers me is that a large portion of the defense purchases are developed with

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Government money and are sole source contracts. Is there no need for any protection at all?

Mr. ZEVENBERGEN. In reality, there are a number of Government employees expert in the matter of understanding profit at Boeing. I cannot understand the question, really, when these people know exactly what the situation is at Boeing. For instance, since that was brought up, these people are residents there and are going over everything daily, so I don't quite see why this is needed.

Senator MORGAN. Well, maybe not. [General laughter.]

Was your company ever involved with the Renegotiation Board?

Mr. ZEVENBERGEN. We had to fill out the reports on an annual basis.

Senator MORGAN. Other than just reports, you were not involved with actual renegotiation?

Mr. ZEVENBERGEN. If the question is, have we ever been forced to give up any profit because of renegotiation, the answer is no.

Senator MORGAN. Let me ask you about one other matter. As you know, the present Vinson-Trammell Act applies only to Navy ships or aircraft. When you sell your products to the Government, do you know where they are going? Do you know whether they are going into ships or aircraft or some other area that would not be covered by it?

Mr. ZEVENBERGEN. Certainly, if you are referring to the earlier question regarding the retroactivity of this Vinson-Trammell Act, I don't see how we would ever resurrect those records and find out where that equipment went.

I think that we would have to be very cautious in the future that we stayed away from that kind of business were this act put into effect.

Senator MORGAN. I believe that covers all of the important questions I have. Senator Humphrey has asked that you answer his questions for the record.

[Questions submitted by Senator Humphrey follow:]

Senator HUMPHREY. I have two questions that I would like to propose to you regarding a risk/benefit analysis of the various proposals on Vinson-Trammel. It is my belief that if we were to leave Vinson-Trammel in place, the bureaucracy required to implement it would outweight the benefits in terms of excess profits returned to the government. Do any of the proposals before the Congress, in your judgment, have enough benefit to outweigh the cost of the bureaucracy enforcing them, and your own industry's cost of complying.

Another argument for some limitation is that it would deter excess profits by the defense industry. In your judgment, would any benefit of deterrence value of any of these alternatives be worth the cost of enforcement and compliance?

Mr. ZEVENBERGEN. The same answer would apply to both cases of collection of excess profits. In my opinion, there is no objective way of measuring the excess. Different industries as well as different companies within an industry may have differing requirements in support of their operations. To attempt to establish by statute a general rule of profit for all industry is, in my opinion, equivalent to attempting to legislate the size of a cloud. It simply cannot be done. The administration of such legislation will ultimately be left to human beings. Such humans have opinions and, contrary to congressional beliefs, make subjective judgments. Needless to say, these judgments are not always agreed to by the industry against which they are applied. The ultimate result of such subjective measurements is an additional load on the appeals process with attendant cost increases. Why is all this necessary? Because of some vague notion in government that some contractors are ripping the government off? Where, outside of the imagination, is the evidence of such practice? To my knowledge, it does not exist.

In spite of the testimony of government witnesses, I cannot conceive how anyone who has not directly experienced the negotiated procurement process can be-

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gin to comprehend its complexity and sophistication. I oftentimes wonder if even this process is cost effective much less the addition of another level of after-the-fact second guessing. It seems to me that if the procurement system has weaknesses, other than overregulation, the place to correct such weaknesses is within the system. It is not by setting up another policeman to watch the policeman. Where does such a practice stop?

The answer then to your questions is that I do not believe any of the proposals concerning excess profit limitations before the Congress at this time could have benefits that outweigh either the cost of enforcement or the cost to industry of compliance.

Senator MORGAN. There are a lot of other questions I could ask you, but we have a full schedule this afternoon. Thank you very much.

Mr. ZEVENBERGEN. Thank you very much.

Senator MORGAN. Congressman Paul McCloskey, you came in just at the right time. We have just heard previously from Congressman Minish, and then Mr. Zevenbergen, of the John Fluke Manufacturing Co. of Seattle.

We welcome you to our side of the Hill, and we will be glad to hear from you.

STATEMENT OF HON. PAUL N. McCLOSKEY, JR., A U.S. REPRESENTATIVE FROM THE STATE OF CALIFORNIA

Representative MCCLOSKEY. Senator, my testimony is in front of you. I will try to be very brief in summarizing what I have to say.

Senator MORGAN. We will make your testimony a part of the record in full, so you may use your time in any way you see fit.

[Mr. McCloskey's prepared statement and attachments follow:]

PREPARED STATEMENT OF REPRESENTATIVE PAUL N. MCCLOSKEY, JR.

Mr. Chairman: I appreciate this opportunity to testify on the Vinson-Trammell Act, which was reinstated into the relationship between the government and the defense contracting industry when Congress cut off funding for the Renegotiation Board a year ago.

The Vinson-Trammell Act is clearly obsolete and would be extremely costly to administer. Enacted in 1934 when aircraft manufacture was in relative infancy, Vinson-Trammell limits profits on ship components to 10 percent and aircraft components to 12 percent, but imposes no limits on profits from other components provided to the government.

Thus a defense radio manufacturer, for example, under Vinson-Trammell, would have to maintain three sets of records: (1) costs allocable to radios furnished for aircraft, (2) radios furnished for ships, and (3) radios furnished for other purposes.

In today's world, the costs of such recordkeeping are obviously a burden we don't want to impose at a time when productivity of U.S. industry is a major goal. This was the very reason we abolished the Renegotiation Board last year; the $200-plus million costs per year of industry just didn't match the net recovery of $10 million or so per year we might reasonably have expected as the result of the Renegotiation Act.

In my judgment, the Vinson-Trammell Act should be abolished as well.

The Defense Department has declined, as far as I know, to offer any testimony, or even suggest, that current law and procedures create any danger of excess profits by defense contractors.

Unless Vinson-Trammell is abolished, the Treasury Department, under current law, will have to apply Vinson-Trammell to contracts going back to September 30, 1976.

S. 1687, introduced by Senators Lugar and Cranston, will accomplish this result. I have appended a copy of H.R. 3254, an identical bill, as Exhibit A to this testimony.

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You also have before you a bill similar to Congressman Patterson's bill, H.R. 5433, which would repeal Vinson-Trammell, but substitute a profit limitation of 15 percent on all sole-source contracts over $5 million . . . roughly 2,000 out of 147,000 sole contracts covering perhaps $23 billion or 57 percent of the total sole-source contracts which add up to roughly $40 billion this year. As I understand it, this is merely an attempt to be political in an election year. The Defense Department makes no contention that *any* of these 2,000 contracts . . . presently, last year, going back to September 30, 1976, or in the future . . . will result in profits over 15 percent. In fact, during the last few years the Renegotiation Board was operating, the firms assessed for excess profits (quite often under 15 percent) were generally small firms, with contracts well under the $5 million limit, and quite often competitive rather than sole source.

Before a new regulatory limitation or procedure is placed on American businesses, it seems to me there should be some showing (other than fear of adverse press) that such limitation is necessary.

Since Vinson-Trammell was enacted we have seen a whole set of laws enacted to protect the government from gouging by defense contractors. Cost Accounting Standards, the Armed Forces Procurement Regulations and the Truth in Negotiations Act all work to assure that the government will not be victimized. In non-emergency circumstances, with contract negotiations conducted without time pressures, there seems to be ample protection against gouging. In the few cases where these protections may permit unexpected profits in excess of 15 percent, the government should ordinarily recover 48 percent of those profits anyway under the income tax laws.

Without a showing of great risk, or indeed of any risk to the government under past practices, why should we impose a future recordkeeping burden on industry as a result of some fear that someone will foul up in the future?

Such a burden might conceivably cause government procurement officers to be a little less rigorous in their scrutiny of sole-source contracts, since there will be an escape-valve for the government. Instead of being accountable for his mistakes, the procurement officer can relax in the knowledge that bureaucrats in another agency will bail him out.

In lieu of passing a new Vinson-Trammell, I would suggest that this committee act to make it clear that the Renegotiation Board can be re-established in event of any future national emergency. This would give protection against future excess profits under emergency circumstances, yet confirm both our appropriation action cutting off the Renegotiation Board last year as well as the continuing process of abolishing pieces of government that most of us have promised our constituents to achieve.

I have attached as Exhibit B to this testimony the House bill which confirms our desire to have the Renegotiation Board on the shelf for such national emergency as the Vinson-Trammell Act would otherwise be applicable.

Thank you.

EXHIBIT A

[H.R. 3254, 96th Congress, 1st session]

A BILL To amend title 10, United States Code, to eliminate certain limitations imposed on excess profits arising from any contract with any military department of the United States for the construction or manufacture of all or part of any complete aircraft or any contract with the Secretary of the Navy for the construction or manufacture of all or part of any complete naval vessel, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 2382 of title 10, United States Code, is repealed.

(b) The table of sections at the beginning of chapter 141 of title 10, United States Code, is amended by striking out the item relating to section 2382.

SEC. 2. (a) Section 7300 of title 10, United States Code, is repealed.

(b) The table of sections at the beginning of chapter 633 of title 10, United States Code, is amended by striking out the item relating to section 7300.

SEC. 3. (a) Sections 7342 and 7343 of title 10, United States Code, are repealed.

(b) The table of sections at the beginning of chapter 635 of title 10 United States Code, is amended by striking out the items relating to sections 7342 and 7343.

SEC. 4. The provisions of the first section and of section 2 of this Act shall apply to contracts entered into after September 30, 1976.

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EXHIBIT B

[H.R. 3112, 96th Congress, 1st session]

A BILL To amend the Renegotiation Act of 1951 to provide that such Act shall only be in effect when the President, during a period of national emergency, determines that having the provisions of such Act in effect would be in the best interest of the country

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the Renegotiation Act of 1951 (50 App. U.S.C. et seq.) is amended by adding at the end thereof the following new section:

"SEC. 205. (a) The provisions of this Act and any recommendations of the President submitted to the Congress pursuant to subsection (b) shall be in effect only when—

"(1) the President determines, during a period of national emergency, that having such provisions in effect would be in the best interest of the United States, and

"(2) neither House of the Congress, within sixty days after the date on which the President submits such determination to the Congress in accordance with subsection (b), passes a resolution disapproving of such determination.

"(b) Upon making a determination under subsection (a), the President shall—

"(1) inform the Congress of such determination, and

"(2) recommend to the Congress any amendments to this Act which he determines are necessary during such period of national emergency.".

EXHIBIT C

During the last three complete years of the Renegotiation Board (1976, 1977 and 1978), 132 companies were assessed for excess profits. In only 7 of those 132 cases, however, did profits exceed 15 percent on sales above $5 million. If those profits in excess of 15 percent were all made on sole-source contracts, an average of $528,373 per year would have been recovered by the DOD proposal over the three year period beyond what normal income taxes would have recovered.

If the costs of complying with DOD's proposed replacement of Vinson-Trammell will cost substantially more than $500,000 per year to the contractors (and be passed on to the government), there would seem to be little reason to adopt the DOD proposal.

	Companies assessed for excess profits	Companies subject to DOD proposal	Profits as a percent of sales	Profits recovered by DOD proposal	Net profits recovered by DOD proposal (after income taxes)
1976	46	0	0	0	0
1976 (transition quarter) (total)	12	1	16.8	$100,332	$52,173
1977	37	2	18.5	2,159,640	1,123,013
			15.4	29,572	15,377
Total				2,189,212	1,138,390
1978	37	4	15.6	48,048	24,985
			16.0	341,150	177,398
			16.9	172,444	89,671
			17.0	197,120	102,502
Total				758,762	394,556
Total				3,048,306	1,585,119
Average per year over 3 yr				1,106,102	528,373

Representative MCCLOSKEY. I have appended two exhibits to my testimony, A and B, which I hope the Senate will enact this year. One would abolish the Vinson-Trammell Act, just repeal it outright. The second would confirm the Congress decision of last year to terminate

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funding for the Renegotiation Board by putting the Board on a standby basis until the next emergency.

I suggest the House and Senate take these actions because I believe the only pressure against outright repeal of Vinson-Trammell is the concern that in an election year, defense contractors will be perceived as somehow getting a special favor from the Congress in the removal of Vinson-Trammell. I don't think there is a Member of Congress who wants Vinson-Trammell to go into effect; but whatever the House and Senate does, I would hope that the period between September 30, 1976, and the end of fiscal year 1981 can be exempted from the provisions of Vinson-Trammell. We should just wipe it out, because otherwise it will impose an unholy burden on both government and business alike.

Senator MORGAN. What was the last date you referred to?

Representative MCCLOSKEY. The end of fiscal year 1981.

Senator MORGAN. Fiscal year 1981.

Representative MCCLOSKEY. That would give the Congress time to enact, if it wishes, a replacement for Vinson-Trammell; but let me go to the primary thrust of my testimony.

The only alternative to outright repeal of Vinson-Trammell appears to be to repeal it and put a 15-percent ceiling on sole-source contracts of $5 million or more. This is the so-called Patterson bill in the House, and I think it is the only real alternative.

I want to speak against that alternative, and I want to direct your attention, Mr. Chairman, to exhibit C, the third exhibit of my testimony. In essence, the argument that there ought to be a cap on profits over 15 percent on sole-source contracts of $5 million or more is based on the idea that we want to prevent large contractors from exploiting the Government for profits over 15 percent.

According to the last three annual reports of the Renegotiation Board, 1976–78, there were 132 cases where the Renegotiation Board attempted to assess excess profits. I say "attempted" because the record of the Board of successfully holding those claims was somewhat dubious, and was one of the reasons Congress abolished the Board last year. But in only 7 of those 132 cases did profits exceed 15 percent on sales above $5 million. In 1976, there was only one case where profits on sales above $5 million exceeded 15 percent; in 1977, there were two cases; and in 1978, there were four cases. If all profits above 15 percent for these seven companies were made on sole-source contracts, the Patterson bill would have recovered an average of $528,373 per year over the 3-year period beyond what normal income taxes would have recovered.

Thus, if the costs of complying with the Patterson bill would exceed a half million dollars per year, there would seem to be little reason to adopt it.

The Government will have established a law only to achieve a political result to quiet fears that the public is somehow being ripped off by these big contractors, and will in effect be imposing upon some 2,000 contractors a requirement of recordkeeping and preparation for dealing with the Federal Government.

In my estimation, it will be an irrelevant procedure. We will be imposing another restriction on business for which no need has been demonstrated.

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Senator MORGAN. So is it your opinion, then, Paul, that the entire act should be repealed?

Representative MCCLOSKEY. That is correct.

Senator MORGAN. If I understand you correctly, and your statement earlier, you recognize the difficulties of this year, with all that we have before us, that it is not likely that we will be able to repeal the entire act, and your suggestion is that we suspend it until the end of the 1981 fiscal year, which would be October 1981, would it not?

Representative MCCLOSKEY. It would be September 30, 1981.

Senator MORGAN. Well, I raised that question earlier. I didn't exactly say October or July, but I think this would be realistic.

Representative MCCLOSKEY. We would create a 5-year gap in any law that applies to excess profits. Since September 30, the Renegotiation Act has not been in effect and Vinson-Trammell has not been enforced. We would extend until September 30, 1981, for another 15 months in essence, the period in which companies would not be required to keep records to comply with the admittedly impossible regulations under Vinson-Trammell.

If the Congress in its wisdom decides next year to pass the so-called Patterson bill or some substitute for Vinson-Trammell, I don't think we will have lost any great amount of money in this 5-year period.

Senator MORGAN. Would it be, in your opinion, basically fair for us to even try to go back to September 1976, when there haven't been regulations promulgated and adopted for the enforcement of it?

Representative MCCLOSKEY. It would neither be fair nor economical. Despite ample warning, since March of last year that the Renegotiation Board was going out of business, the Treasury Department has not even been able to promulgate regulations to make business comply with Vinson-Trammell. It is absurd. Even if there were excess profits during this 5-year period, the Government would get 48 percent of the profits back under the Federal income tax anyway, and the record of the Renegotiation Board, whose profit limits were far tougher than Vinson-Trammell, indicates that there was not a great amount that would be at stake even under the 19 and 12 percent limitations.

I found the only excess profits of more than 10 or 12 percent were in very small companies in very small contracts.

Senator MORGAN. Congressman, thank you very much. You have been a great deal of help to this committee.

Representative MCCLOSKEY. Mr. Chairman, if I may, I would like to add one argument which is in my written statement.

I think there is incredible activity in the business community these days to come up with constructive suggestions on how to amend the law specifically and to cut regulations specifically. I know our colleagues in both the House and Senate want to cut the size of Government wherever they can. One of the best results of abolishing the Renegotiation Board last year was that it gave to the business community a feeling of confidence that Congress is capable of cutting the size, cost, and complexity of Government, when given specific input as to how to do it.

I would like to keep that momentum up. Though I am afraid we are not going to have time either in the House or the Senate in the balance of this election year to give this issue appropriate attention,

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a temporary repeal of Vinson-Trammell would keep the momentum IRS to administer Vinson-Trammell, both retroactively and during going of cutting a Government agency by ending the need for the the next 15 months. I think Congress would show the American public we are capable of cutting the size of Government, and I think we can stand politically the concern that profits over 15 percent might somehow occur in the process. But we just can't administer a law which applies 10 percent to ships, 12 percent to aircraft, and no limitation at all to tanks or infantry weapons.

A radio company that tries to operate under Vinson-Trammell would have to keep three sets of records: one for ships, one for tanks, and one for aircraft, even though it was making essentially the same product. This is absurd. I hope it will convince you of the need to repeal Vinson-Trammell. I think I can assure you that a majority of the Members of the House would cheerfully join in abolishing it for at least 5 years.

Senator MORGAN. Good. Thank you very much, Congressman. I have several questions from Senator Humphrey to be answered for the record.

[Questions from Senator Humphrey follow:]

QUESTIONS SUBMITTED BY SENATOR GORDON HUMPHREY

Question. You mentioned in your remarks that as a hedge against Congress not acting on Vinson-Trammell this year we should stay the implementation of the Act as it now stands. Would you please elaborate on the language you have in mind?

Answer. I would recommend the following language be used to place a moratorium on Vinson-Trammell from its effective date of October 1, 1976 until the end of this coming fiscal year:

TEMPORARY WAIVER OF PROFIT LIMITATION PROVISIONS

Sec. 805. The provisions of sections 2382 and 7300 of title 10, United States Code, relating to profit limitation on contracts for the construction or manufacture of aircraft and naval vessels and parts thereof, shall not apply to any contract completed before October 1, 1981, and to receipts or accruals reasonably attributable to performance before October 1, 1981, under any contract not completed before October 1, 1981.

Question. What are your views on whether it would be better to put more pressure on procurement officers to more efficiently oversee contracts rather than relying on artificial means like Vinson-Trammell.

Answer. As it stands, Vinson-Trammell gives procurement officers freedom from accountability for sloppy work. If they know in advance that the taxpayers will have to pay for their mistakes (as will their own service reputations), it should motivate higher performances.

Question. What do you have in mind about emergency powers of the President to limit profits?

Answer. Appended to my written statement is a bill I have introduced in the House which gives the President authority to reestablish the Renegotiation Board during a period of national emergency. Only during wartime or emergency, when normal contracting procedures must give way to emergency needs, should the government be given greater protection than ordinary negotiators dealing at arms length.

Under my bill, in the event of a future emergency, the President could immediately reconstitute and reactivate the Renegotiation Board . . . something he could do now if he could convince Congress to provide the funding.

Senator MORGAN. We will move on now to the General Accounting Office. Mr. Sheley is the Deputy Director of Procurement and Systems Acquisition Division.

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Mr. Sheley, we welcome you. If you would identify the people accompanying you.

STATEMENT OF WALTON H. SHELEY, DEPUTY DIRECTOR, PROCUREMENT AND SYSTEMS ACQUISITION DIVISION, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY JOHN FLYNN, ASSOCIATE DIRECTOR, AND JOHN POTOCHNEY, STAFF

Mr. SHELEY. On my right is Mr. John Flynn, Associate Director in our Division, and Mr. John Potochney of our staff. He does a considerable amount of work in the area of pricing, contract review, and Vinson-Trammell.

For the sake of brevity, I would like to submit our formal statement for the record, but there are several points in our statement which I would like to stress and discuss with you, if you agree to that.

Senator MORGAN. All right, that is fine. We will make your entire statement a part of the record.

[The prepared statement of Mr. Sheley follows:]

PREPARED STATEMENT OF WALTON H. SHELEY, DEPUTY DIRECTOR, PROCUREMENT AND SYSTEMS ACQUISITION DIVISION

Mr. Chairman and members of the committee: At your request, we are here today to present our views with respect to the Vinson-Trammell Act and the need for profit limitation legislation. This Act, as you know, has been dormant for many years because of the Renegotiation Act which was passed in 1951. With the abolition of the Renegotiation Board last year, it again became operative. The Internal Revenue Service, which has enforcement responsibility, has been delaying implementation because it recognized the inherent limitations of Vinson-Trammell and the difficulties of enforcement.

There is almost unanimous agreement, both inside and outside of Government, that the Vinson-Trammell Act is not workable. The defense procurement picture has changed so radically since its passage that it is no longer relevant. The dollar threshold is far too low—many thousands of small contracts with relatively miniscule profits would be covered—creating a paper avalanche that would serve no useful purpose. The classification of items covered (only ships and aircraft) is so restrictive that it will exclude many major procurements, while at the same time being so imprecise as to be impossible to enforce. We, therefore, join with all of the other government and industry witnesses who have urged prompt repeal.

As we all recognize, the subject of profit limitation is both exceedingly complex and controversial. Contractors, naturally, would prefer to see no profit limitations imposed after a contract is negotiated and performed. On the other hand, there are many in Government and Congress who feel that such a profit limitation, either on a contract-by-contract basis, or based on a contractor's total work for the Government, is both necessary and desirable.

The principal arguments in favor of the first approach are as follows:

1. The primary emphasis in Government contracting should be on the negotiation of a price to the Government based on maximum competition and on full disclosure of contractors' costs.

2. Profit limitations tend to reduce the contractors' incentive to increase efficiencies which are translated into lower costs on subsequent or follow-on contracts.

3. The Truth in Negotiations Act, the Cost Accounting Standards Act, and profit guidelines such as those utilized by the Defense Department, together provide a fair element of protection to the Government and represent major improvements in the contracting process unavailable at the time of enactment of either the Renegotiation Act or the Vinson-Trammell Act.

Arguments in favor of some form of profit limitation are as follows:

Even though there have been significant improvements in the Government's ability to negotiate and monitor contracts, the possibility still exists that excessive profits can be a problem on a limited number of contracts;

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As a matter of public policy, it is generally agreed that contractors should not earn excessive profits at the expense of the Government;

From the standpoint of public trust and confidence in the Government procurement process, there should be some assurance that contractors will not get "fat" on public moneys.

It must be recognized that no statute will satisfactorily address all of the concerns of interested parties. There are a number of issues that should be addressed in developing a statute that is both equitable and workable—such as:

1. How to limit profits and still motivate contractors to invest capital, increase productivity, and delivery quality products.
2. What dollar threshold should apply.
3. Should both competitive and non-competitive contracts be covered.
4. Should the limitations apply on a contract-by-contract basis or on some aggregate business base.
5. What levels of contracting should be covered—prime, first tier subcontracts, lower tiers.
6. How can excessive profits be defined.
7. How can the profit limitation activity be administered at a relatively low cost.

The Renegotiation Act died because industry claimed, and the Congress agreed, that (1) excess profits were not consistently and equitably defined and (2) the costs of administration probably exceeded the benefits to the Government. With respect to this latter point, I don't believe it will ever be possible to measure costs vs. benefits of any profit limiting statute because the benefits being sought are largely intangible. This does not mean, however, that every effort should not be made to keep any new statute as simple as possible.

There are several suggestions I would like to offer for your consideration with respect to the several bills already introduced, or to others that may be introduced at a later date.

A profit limitation based on a fixed percentage of contract costs can result in inequities and could be counterproductive. There could be many instances where the circumstances warrant higher profits than those that would be specified in a statute.

A profit limit based on an aggregate business basis is difficult to administer. A better solution is somewhat of a compromise—limits on individual contracts with provision to offset losses on specific contracts against profits. Something similar to the carry-forward and carry-back income tax treatment for capital losses.

While any dollar threshold is arbitrary, anything lower than a $5 to $10 million range will today result in coverage of too many small contracts. A continued high rate of inflation would soon make even that figure unrealistic, and the legislation should probably include some indexing procedure to keep up with rising prices. Failure to keep the threshold realistic will soon have a severe adverse impact on small business.

If the Congress decides to enact new legislation, we would therefore like to suggest that it include provisions along the following lines:

1. Limit its application to negotiated prime contracts and subcontracts exceeding $10 million.
2. Permit retention of profits equal to a percentage of the negotiated dollar amount (i.e. 125 percent or 150 percent). (See chart attached.)
3. Permit carry-forward of losses, to offset excessive profits, for a 3-year period.
4. Provide for filing of certified statements with the contracting officers on conclusion of individual contracts, subject to audit by GAO and executive agency internal auditors.

There is one other point that I would like to bring to your attention. When profit limitation statutes were first proposed, there were no really major nondefense contracts. The pattern of Government spending has changed over the years and agencies like NASA, DOT, GSA, DOE, make major contract awards. At this point in time, there is no reason to single out defense contracts for profit limitation—and the Congress should consider making any new statute applicable to all Government contracts and expenditures with grant funds.

In conclusion, while the General Accounting Office agrees that the Vinson-Trammell Act is outdated and should be replaced, we believe that the question of whether or not this Act should be replaced with a new statute is a matter of policy which the Congress should determine after considering all of the advantages and disadvantages. As a minimum, we would suggest that a profit limitation

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statute, that would become operative during a period of national emergency when contract activities increase significantly, should be in place. We would also suggest, as a minimum, that the secretaries of the various agencies have the right to promulgate regulations that would limit profits in those cases where sole-source contractors are attempting to take unconscionable advantage of the situation.

This concludes my prepared statement, I will be happy to answer any questions you may have at this time.

Example of excess profit computation

Negotiated contract cost	10,000,000
Negotiated profit (15 pct)	1,500,000
Contract price	11,500,000
Actual cost	8,500,000
Actual profit (35 pct)	3,000,000
Contract price	11,500,000
Negotiated profit	1,500,000
Maximum allowable (150 pct)	2,250,000
Refund due Government	750,000

Net profit percentage earned by contractor:

$$\frac{\$2,250,000}{8,500,000} = 26 \text{ percent}$$

Mr. SHELEY. What I would like to talk about first are several of the suggestions that have been made with regard to bills already introduced. There are some six or seven bills, I believe, right now, dealing with repeal or modification of Vinson-Trammell.

One of the things that concerns us is that a profit limitation based upon a fixed percentage of contract cost can result in inequities and could be counterproductive. There could be many instances where higher rates are warranted and should be specified, but would be limited by a statute. A profit limit based upon an aggregate business basis is also difficult to administer.

A better solution is somewhat of a compromise: Limits on individual contracts, with provisions to offset losses on specific contracts against profits, something similar to the carryforward, carryback income tax treatment for capital losses.

While any dollar threshold is arbitrary, anything lower than roughly the $5 million to $10 million range today will result in coverage of many small contracts which should probably not be covered. In considering the rate of inflation today, even that figure may be out of date very shortly. If the Congress decides to enact new legislation, we would therefore like to suggest it include provisions somewhat along the following lines:

That it limit its application to negotiated prime contracts and subcontracts exceeding a range of $5 million to $10 million; permit retention of profits equal to a percentage of the negotiated dollar amount, and we have attached a computation in our statement showing how this would work. It would permit carry-forward losses to offset excessive profits for a 3- to 4-year period, and would requiring filing of certified statements with contracting officers at the conclusion of individual contracts and these would be subject to audit by GAO and executive agency internal auditors.

There are several other points I would like to make. One is that when profit limitation statutes were first proposed, they were proposed as

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being applicable to major defense contracts. Today, there are many agencies in the civil side of Government which enter into negotiated contracts; for example, NASA, the Department of Transportation, General Services Administration, and the Department of Energy. If any kind of profit limitation statute is enacted or amended, I would think these contracts should be made subject to the same types of limitations.

Senator MORGAN. Mr. Sheley, are there any laws now that deal with the profits with NASA contractors or others?

Mr. SHELEY. To my knowledge, there are not. Public Law 87–653, which is the one dealing with defective pricing, is applicable to defense contracts. I think it is used by NASA as a guideline, but I don't know how legally binding it is.

Mr. FLYNN. They have the Federal procurement regulations on the civil side which include similar procedures. However, Public Law 87–653 in no way limits profits. All it calls for is accurate, complete, and current data. Any contractor can comply completely with that statute and still insist on any profit he wants to ask for, and if he is in a sole source situation, the Government may end up paying it.

Senator MORGAN. What is Public Law 87–653?

Mr. SHELEY. The Truth in Negotiations Act.

There is one additional point Congressman Minish made reference to, and this is, in this era of probably expanding defense expenditures, we have noted the Department of Defense is now having to go forward on occasional cases to invoke the Defense Production Act, in other words, to allocate to specific contractors work required in the interest of national defense.

It is not a great many cases at this point, but as work expands and you want to increase airframe manufacture, for example, there are limited numbers of companies who can supply certain types of materials. They are already booked to the limit with commercial as well as military orders, and if this has to be invoked, there is no assurance whatsoever of establishing a reasonable profit in that type of allocation.

That contractor is in effect a sole source contractor, and he is sitting there and can demand his price. We would suggest something along the lines of providing for some third party to arbitrate or agree to a reasonable rate of profit where those types of contract set-asides would be appropriate.

In conclusion, I think the General Accounting Office agrees that Vinson-Trammell is outdated and should be replaced. How far you want to go in replacing it is a matter of policy determination by the Congress, but we would like to see at an absolute minimum standby authority in the case of an emergency situation. We certainly would not object to peacetime legislation.

Senator MORGAN. Then. to summarize, your suggestion with regard to the threshold is $10 million?

Mr. SHELEY. $5 million to $10 million. I think the numbers of contracts involved above $5 million is something like 0.6 of 1 percent of the total contract awards by DOD that are over $10,000.

Mr. FLYNN. I think it is important to note that we just discussed setting a fair profit at the time of negotiating contracts. This is ex-

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tremely important in situations where you are dealing with a sole source. In this regard, we suggest that the criteria of Public Law 87–653 be used. This would make the procedure we are recommending applicable to those sole source negotiated procurements and contract modifications in excess of $100,000 where the contractor and the Government could not agree on the contract profit. Then a third party would step in and set a binding amount. In such cases, then, it wouldn't be too important for any Excess Profits Act to take effect at a much higher dollar level.

Senator MORGAN. You would also recommend, then, that it go to prime and subcontractors?

Mr. SHELEY. Yes, sir.

Senator MORGAN. And that it apply only to negotiated contracts?

Mr. SHELEY. Yes. I think for those normally allocated in the commercial marketplace where there is true and sufficient competition, I don't think we need to worry too much about.

Senator MORGAN. Instead of making it apply only to ships or planes, you wouldn't make it apply to all items?

Mr. SHELEY. Absolutely.

Senator MORGAN. You also recommended with regard to profit level, 125 to 150 percent of contract profit level.

Mr. SHELEY. Contract price originally negotiated. If you will refer to the computation attached to our statement, I think you can see how this might work. What we are saying under these circumstances, Mr. Chairman, is that a contractor ought to have some incentive to earn from his ingenuity, innovativeness, and capital investments made subsequent to the time the contract was awarded, but there should be some limits on that. If it is agreed to, whatever that agreed to amount is, up front at the time the contract is negotiated, it puts a cap on the amount of profit that can be earned on that specific contract.

Senator MORGAN. How did you arrive at that figure?

Mr. SHELEY. It was rather out of the air. You could pick any figure you want. We just happened to use that particular figure.

Senator MORGAN. Mr. Sheley, suppose Congress decided to do nothing on this matter, and the IRS proceeds to adopt regulations. Do you think it would be feasible or practical or economic for the Government to try to apply it retroactively to September 1976?

Mr. SHELEY. It would be very difficult to do, Mr. Chairman, mainly because during this period of time the industry has been working without any guidelines at all. They don't know what the rules of the game are, and all of a sudden we would be retroactively imposing upon them rules of the game which may or may not be appropriate under the circumstances.

For example, there is a large argument between DOD and IRS as to how to determine the allowable costs under these contracts.

Senator MORGAN. Well, now, asking for your opinion on an equitable standpoint, do you think it would be fair or equitable to try to proceed to enforce a law such as this retroactively when the Government had failed to promulgate the rules and regulations?

Mr. SHELEY. As a matter of equity, I would say it would not be fair to do so.

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Senator MORGAN. I don't know whether the clean hands doctrine would apply or not. [General laughter.]

It would be hard for us to come in saying we were late in doing our work, but we will hold you responsible.

Mr. SHELEY. That is the way I would come at it.

Senator MORGAN. The staff has the burdensome work in this matter, and they have prepared some questions which I think are relevant. Let's take a little time and proceed on these.

As background to our discussion today, would you describe for the subcommittee in general what the profit levels in the defense industries are today?

Mr. FLYNN. We don't have those figures today. We made a study back in 1970, but profits have changed considerably since that time. The Department of Defense conducted a similar study in 1976, and the rates at that time, as a percentage of sales, were running about 4.7 percent for defense work. The rate for comparable commercial contractors, some 5,000 durable goods manufacturers who report to the Federal Trade Commission, was 6.7 percent.

When you look at it in terms of return on contractor total capital investment involved in performing those contracts, however, the rate of return on defense sales was 13.5 percent, whereas the rate of return on the durable goods manufacturers was 10.7 percent.

The reason the profit relationship changes is the factor of government-furnished capital in the form of progress payments, assets, and so forth. This means that much less contractor capital is required to perform defense contracts and, therefore, they make a higher rate of return.

Mr. SHELEY. On that capital they do have invested.

Mr. FLYNN. That is right.

Since 1976, the rates have gone up appreciably. Defense just recently increased the rate of return allowed on capital assets required for contract performance. The range previously was 6 to 10 percent. They have increased it to 16 to 20 percent and this can make a substantial difference.

Mr. SHELEY. That is the total target profit they are negotiating, not a rate on the total cost.

Mr. FLYNN. That is one element of their weighted guidelines formula. These are other allowances based on cost and so forth. I would guess their current rate of going-in profit for higher risk type contracts is in the range of 13 to 14 percent of anticipated contract costs. On cost type contracts I would guess it is probably in the range of 6 to 9 percent.

Of course, the coming out rate is usually less, but in any event, it is probably somewhat below the 15 percent rate being considered.

Senator MORGAN. Are there differences in the profit levels among various segments of the defense industry?

Mr. FLYNN. Very great differences.

Mr. SHELEY. Very greatly, sir.

Senator MORGAN. I am talking about aircraft manufacturers and electronic manufacturers, for example.

Mr. SHELEY. Most electronic products have a higher rate of profits.

Mr. FLYNN. There are very great differences. The steel industry is

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depressed, and their profit rate is very low. You get some variances all the way across the line. That is why we have urged Department of Defense personnel, when negotiating profit rates, to consider the industry profit rates with which they are dealing. It does not make much sense to use an overall average rate. A company in a low-profit industry will grab the rate offered while a high-profit one will insist on a much higher rate than the Defense's average rate.

Senator MORGAN. Are there similar differences in the profitability of different types of products within the same companies?

Mr. SHELEY. I suspect Boeing probably makes more on some lines of their government business than on others. I would say probably it would not be too much different in the electronics.

Senator MORGAN. In looking at the profits earned by defense contractors, what is the relationship between the going-in profit level on the contract and the final profit?

Mr. SHELEY. Generally speaking, the final profit is somewhat less than the going-in profit.

Senator MORGAN. What is meant by the going-in profit?

Mr. SHELEY. That is what you negotiated up front.

Senator MORGAN. What you hope to make, what the company hopes to make?

Mr. SHELEY. Yes.

Senator MORGAN. And in general the profit is not quite as much?

Mr. SHELEY. For various reasons. Sometimes unallowable cost explains part of it. Other times there are cost increases not compensated for by increases in the contract base value. Various factors cause the coming out profit to be a little lower than the going-in profit.

Senator MORGAN. My next question was going to be—do your studies show any pattern there, but when you say generally, I assume that is based upon a pattern.

Mr. SHELEY. It is based upon a pattern, sir.

Senator MORGAN. Mr. Sheley, when you measure the profit levels of defense contractors, do you use profit on sales, profit as a percentage of invested capital, or profit as a percentage of equity, or some other measure?

Mr. SHELEY. We would probably use several factors. One of the few we would not use probably is percentage of sales. We would more tend to recognize profit as a percentage of the cost incurred, or return on capital equity.

Mr. FLYNN. What we did in our study was to look at it three ways. We looked at it in terms of profit on sales, profit in terms of total capital investment required for contractor performance, and profit on equity capital. We think the fairest way is probably the rate of return on total capital investment required to perform a contract regardless of the source of the funds, whether they are borrowed or provided by the stockholders.

Senator MORGAN. I believe you said the one you would not use would be profit on sales.

Mr. SHELEY. We measured it in one instance, but I don't think we would use it as a normal measure. In establishing profit weighted guidelines, they do not provide for profit on sales, they provide for profit on costs. That is one of the elements. That is the way we would

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view it. That is, what did you intend when you went into the contract, and how did you come out? The measure there would be based upon percentage of incurred cost.

Senator MORGAN. I believe the Vinson-Trammell Act sets the measure as being profit on sales.

Mr. SHELEY. It is murky.

Mr. FLYNN. The disadvantage is, it fails to consider the period of time involved in performing the contract or the capital investment required, and, thus, can be totally inequitable. For example, if a contractor turns over his capital three times, he will have three times the profit of the contractor who has a single rate of turnover.

Senator MORGAN. Mr. Sheley, in your prepared testimony, you have stated that putting in law precise profit figures as percentage of sales is an unworkable method of controlling profits. Could you discuss this a little more fully, and why it does not work?

Mr. SHELEY. If you set the percentage too low, you drive away the efficient contractor, and you guarantee award to the inefficient contractor who is willing to settle for a lesser amount of profit and more Government assistance in his facilities, and you will stifle the innovation of that contractor, particularly if it is the kind of contract which has follow-on procurement potential. There is no incentive for him to be efficient on the first contract. If you put an arbitrary ceiling on him and say, thou shalt not earn more than 10 or 12 percent, he will not be efficient.

Senator MORGAN. Is that what you meant in the early part of your statement when you said it could be counterproductive?

Mr. SHELEY. Yes, sir.

Senator MORGAN. In discussing the 10- and 12-percent limits now in law, you state on page 4 of your statement there "could be many instances where the circumstances warrant higher profits than specified in the statute." Could you give us some kind of example here of what situations would warrant higher profits?

Mr. SHELEY. Primarily in the high technology areas. They are expensive to develop. The risk is high. The payoff may be great or may not be great, and under those circumstances, a higher than normal profit I think would be warranted to the contractor willing to take those kinds of risks.

Senator MORGAN. I would be interested in your opinion as to what are the causes of excess profits when they do occur? Is it the result of bad contracting practices by the Defense Department? Or do they result from incomplete cost information? Or is it uncertainty about technology that we don't know about? Or cost reduction by contractors? What are some of the factors that might be included?

Mr. SHELEY. Let me try a few of them, and then Mr. Flynn may have some ideas too.

Technology changes can result in efficiencies. I recall a case many years ago when titanium was first coming into use. It was a very difficult metal to work with. The scrap rates were fantastic. The particular contractor developed the means of reducing the titanium scrap rate from 25 percent to 2 percent. This resulted in substantial profits.

We wouldn't have had any problem on one contract where he developed the technique, but on follow-on contracts he didn't pass the

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savings on to us. We collected some money back on that. But that type of thing happens.

There are problems sometimes, and they are a lot less than they were many years ago, in negotiating or establishing fair cost or performance at the beginning of the contract.

I think Public Law 87–653 has had a salutory effect in that area, but there are cases where people make mistakes. It still happens.

John, do you want to build on those two?

Mr. FLYNN. Yes. We looked into the causes of excess profits. In fact, we issued a report back in December 1975, where we looked into contracts that had been settled in the prior, I believe, 2 or 3 years. At that time there were shortages of many items and many of the contracts were being assigned for performance under provisions of the Defense Production Act. We also found that in a lot of cases, even where the contracts were advertised and there was the appearance of competition, prices were high and excess profits resulted. A contractor would place a high bid simply to keep his name on the bidders' list and even though he did not expect to get the contract, surprisingly he got some of those awards.

So, the appearance of competition did not protect the Government or prevent excessive profits. The real factor was a shortage situation where people were selling all they could produce, and profits just rolled up tremendously.

Senator MORGAN. Your own recommendations and the recommendations of the Patterson bill include the feature, as I understand it, that profit limitations would apply only to sole source or negotiated contracts or not fully competitive ones. Now, haven't you just given us an example of circumstances where maybe an unconscionable profit could be made under a sole bid contract?

Mr. FLYNN. It could happen, but we also recommended a new procedure be set up, new legislation to permit establishing a fair profit rate at the time a contract is negotiated. If this is done, and if at that time the rate of return on capital is considered so that you do get a fair rate, the situation discussed can probably be avoided, for such cases where all bids are unreasonable, we would be relying on the contracting officer to reject all bids and go to the negotiated procurement method.

Mr. SHELEY. I qualified it where there is a situation of true competition available, and what Mr. Flynn is describing is the procedure available to a contracting officer if he determines that true competition is not available. He can reject bids and go on a negotiated basis, and in those circumstances it would be subject to a profit limitation.

Senator MORGAN. What about where the contract at the time is truly competitive, but things happen afterwards?

Mr. FLYNN. One of the things that we noticed that happened was, the contractor's business increased tremendously as a result of the Government contracts and his production costs dropped substantially, and this resulted in excess profits.

Mr. SHELEY. I think they are talking about something else, if it is awarded on a competitive basis and he turns around and makes a relatively high profit. A contract awarded on a competitive basis is awarded to the low bidder using total price and the elements of price are not considered in that case.

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Senator MORGAN. I don't mean to be picking on Boeing, but they just happen to be on the cover of Time this week, and I really don't know anything about the contract, but I assume no more tests have been made, that there is still a lot to be learned about a cruise missile.

Now, under normal circumstances as they proceed to produce these missiles they run into difficulties unexpectedly. They don't perform quite as well as we had anticipated.

Mr. SHELEY. That is a negotiated contract, and when you talk about a $4 million award, I think you are referring to a $4 billion program. The initial award on that was considerably less than that. It was in the $100 million area, in the initial stages.

Senator MORGAN. They learned during that first increment that terms may be either more expensive or more cost efficient.

Mr. FLYNN. We don't know the type of contract involved. If it is an incentive type, there may be a target price they would be aiming at, and the profit might relate to how far they came under that price.

There are many types of contracts that could be utilized.

Senator MORGAN. Has your experience indicated that the contracts which have resulted in excess profits in the past have generally been sole source, negotiated contracts?

Mr. SHELEY. Many have been negotiated contracts, primarily sole source.

Senator MORGAN. Should there be a limit for the purchase of commercial off-the-shelf products such as the gentleman before you testified to?

Mr. SHELEY. I think the marketplace should regulate the prices of those adequately, and they could be very well accepted.

Senator MORGAN. Approach it with open eyes?

Mr. SHELEY. Yes.

Mr. FLYNN. And if there is true competition.

Senator MORGAN. Has GAO any studies on the cost of complying with the Vinson-Trammell Act as it is now written?

Mr. SHELEY. No, sir, we have no basis in determining those costs. It has not been in force. I don't know how we would ever arrive at it. Anything we would come up with would be pure conjecture.

Mr. FLYNN. We did look into the cost of complying with the Renegotiation Act, and we found that the data base was very poor. It was extremely difficult to pin down what the costs were. We would have people, after the fact, estimating how much time was involved. We found it was almost impossible to tell what it really did cost, and we would expect that it would be the same way in this case.

Mr. SHELEY. We reported to Chairman Proxmire in 1977 on that very factor. It is just totally impossible to arrive at the cost of conforming to either the Cost Accounting Standards Board or whatever. There is just no way.

Senator MORGAN. Is it your view that administrative costs imposed on contractors would be much more serious in the case of the small subcontractor than it would be for a large contractor?

Mr. SHELEY. As a percentage of total burden, yes, sir, I would say, because they are not accustomed to dealing with the myriad of regulations and so forth.

Senator MORGAN. They are not as well equipped?

Mr. SHELEY. They don't have the counsel available.

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Senator MORGAN. In your prepared testimony you state your conclusion that profit controls based upon the aggregate defense business done by a company during a particular period would be hard to administer, that a contract-by-contract system would be better. Could you elaborate on that?

Mr. SHELEY. A contract-by-contract system would provide a less complex means of administering profit controls. Not only are affected contracts more readily identifiable, but profits can be determined with reasonable certainty when units are delivered or at contract completion. This approach is close to the unit of delivery method of revenue recognition under Government contracts used by industry. Under this method, revenue and expenses are recognized as completed units are delivered to the Government.

Senator MORGAN. Let me ask you this one. Do the proposed Vinson-Trammell regulations include any incentive awards to the contract price? The contractor has no motivation to earn these awards if he is close to the allowable profit. That would simply be recovered by the Government. Should a contractor be allowed to earn incentive awards in addition to specified profits?

Mr. SHELEY. I believe he should be, sir. If we impose upon him a penalty or incentive in the way of profits for doing a poor or good job, then I think he should earn the benefits if he does perform in an efficient manner.

Senator MORGAN. Do you agree with those who contend it is hard to trace a product as to whether or not it is going into an aircraft or a ship?

Mr. SHELEY. It depends upon which tier you are talking about. The further down in the subcontracting process it goes, it gets more difficult. A first tier subcontractor ought to pretty well know where his product is going. When he begins buying bits and pieces from second, third, and fourth tiers, he would have a difficult time there telling the source where the items are going and they have no idea what the end product is on that.

Senator MORGAN. Gentlemen, I think we have covered the questions that our staff has prepared, except for one. Before I give you that one, let me say that Senator Humphrey has submitted some questions which would be helpful if you could answer for the record.

Mr. SHELEY. We would be pleased to do so, Mr. Chairman.

[Questions with answers supplied follow:]

QUESTIONS SUBMITTED BY SENATOR GORDON J. HUMPHREY, ANSWERS SUPPLIED BY MR. SHELEY, GENERAL ACCOUNTING OFFICE

Question. Mr. Sheley, it is generally felt that Vinson-Trammell should be repealed. The question is whether or not legislation limiting profits should be passed in its stead. You list in your formal testimony some of the reasons most often cited for maintaining some form of profit limiting legislation. Among these you include the argument that "some form of profit limitation is advisable because despite improvements in contract monitoring" excessive profits can be a problem on a limited number of contracts and that "from the standpoint of public trust and confidence . . . there should be some assurance that contracts will not get "fat" on public monies. This last sentence is reminiscent of Dale Church's statement before this Subcommittee that DOD believe some profit limiting legislation is necessary "even if it were seldom invoked to recoup excessive profits as it would provide the public a measure of assurance that our contracting system is working well."

Mr. Sheley, it seems to be that the DOD is interested in profit legislation—

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legislation by the way which would only add to the regulatory hassle already plaguing industry—for essentially public relations reasons. Isn't it true that "Profit 76" and other studies conducted by Government and private organizations indicate that profits on defense contracts are well below comparable commercial enterprises?

Is it not true that:

(1) The Government already has full access to contractor cost data on all negotiated contracts (Public Law 87–653)—Truth in Negotiation and Defective Pricing);

(2) The Defense Contract Audit Agency performs both preaward and post-award audits of contractors records on all significant negotiated contracts;

(3) "Profit 76" and subsequent studies indicate profits on defense contracts are well below comparable commercial enterprises;

(4) Sophisticated contractor management reporting and contractor performance measurement systems are already imposed on contract on all significant negotiated defense contracts;

(5) All contractors in excess of $10,000, except those resulting from formal advertising, are required to provide for examination of records by the Comptroller General;

(6) All payments to a contractor must be supported by a DOD approved voucher thus ensuring only contractually authorized payments;

(7) Government representatives are located in most large contractor facilities to ensure proper fulfillment of contract terms and conditions; and

(8) Government procurement officials have a wide range of contracting options available to them to limit profit ranging from Cost Plus a Fixed Fee to Firm Fixed Price contracts.

Answer. We can assure you that our support for some form of profit limitation is not for "public relations" purposes. As pointed out in our testimony, this is a time of expanding defense needs and the Government is already experiencing a number of tight supply situations. As a result, during the last six months the Department of Commerce had over 100 requests for special priority assistance to be provided under the Defense Production Act. The situation will probably get much worse and under such conditions excess profits are not uncommon.

You asked if it isn't true that "Profit 76" and other studies indicate that profits on defense contracts are well below profits for comparable commercial enterprises?

The DOD "Profit 76" study and other studies do indicate that the average profit on defense work, when computed as a percent of sales, is below the profit on comparable commercial work. However, we believe that a more meaningful criteria is the rate of return on contractor investments in facilities, equipment, inventories, and other assets required for contract performance. On this basis the "Profit 76" report noted that the average rate of return on Government work was higher than the average rate of return reported by the Federal Trade Commission for comparable commercial work. (The FTC data is based on information routinely gathered from 5,000 corporations producing durable goods with aggregate average sales of $450 billion annually.) The higher rate of return on contractors' investments relating to Government sales had been found in prior profit studies and came as no surprise to the DOD study group.

In questioning the need for legislation limiting profits, you also mentioned Public Law 87–653 and other improvements made over the past several years with respect to the award and administration of Government contracts. As pointed out in our testimony, Public Law 87–653 simply provides for contracting officers to obtain accurate, complete, and current cost or pricing data from contractor's in negotiating contracts (or contract modification) in excess of $100,000. There is no requirement for the contractor to use this data to establish or justify the price at which he is willing to contract with the Government. As long as a contractor furnishes the required cost or pricing data, he can set the price at which he will do the work, and, if a sole source situation is involved, the Government may have no alternative but to pay the contractor's price.

In this regard, as mentioned in our testimony, several years ago we conducted a review to determine the causes of excess profits. In this review we examined a sample of excessive profits determinations by the Renegotiation Board during the years 1970 through 1973. We found that the excess profits were attributable to a seller's market. Despite all the contracting improvements that had been made, they did not prevent contractors from charging excessive prices in a period of tight supplies and shortages.

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As you probably know, Title I of the Defense Production Act provides for mandatory contractor acceptance of defense contracts, and for giving them priority over other work, but there is no provision in that law for pricing such contracts. We believe there is a serious need, particularly in sole source situations, for legislation to deal with instances where the Government contract negotiator and the contractor cannot agree on contract prices. One possibility would be to establish an independent third party with the power to set fair and reasonable prices that would be binding on both the Government and the contractor.

In our opinion, while a provision for recouping excess profits is desirable, such a provision would not necessarily discourage excess profits. This is because the after-the-fact determination of and recoupment of such profits would still enable the contractors involved to profit from the interest free use of such funds for long periods of time. Thus, we believe it is probably more important to provide a means for assuring the establishment of fair and reasonable prices at the time of contract award and that such action would prevent excess profits from occurring in many cases.

Question. In your prepared statement, Mr. Sheley, you argue that: "A profit limitation based on a fixed percentage of contract costs can result in inequities and could be counterproductive. There would be many instances where the circumstances warrant higher profits than those specified in the statute."

Can this be interpreted to mean that the GAO would not favor S. 2331 which defines excess profit as "that greater than 15 percent of the total final contract price."?

Answer. We believe it would be undesirable to define excess profits as a fixed percentage of the contract price. Such a provision gives no consideration to the length of the period of contract performance or the contractor's investment tied up in contract performance. It can be very inequitable. For example, assume that two contractors are awarded contracts for $10 million each with both requiring a $5 million average contractor investment in facilities and other assets throughout contract performance. One contract is completed in one year and the second takes 3 years to perform. Under the proposed legislation, each contract would be limited to a maximum rate of profit of 15 percent or $1.5 million. The annualized rates of return on the contractor's investments are as follows:

One year contractor—$1.5 million÷$5 million=30 percent.

3 year contractor—$1.5 million÷$5 million=30÷3=10 percent.

We believe a preferable system would be to base the excess profits determination on a percentage of the rate of profit negotiated at the time of contract award. For example, any amount in excess of some percentage such as 115 or 125 percent of the negotiated contract profit. This would mean the profit allowed would have a relationship to factors considered at the time of contract award such as risk, complexity of the task, and contractor's investment required for contract performance. We realize that, to date, little consideration has been given to the latter factor, but believe such consideration is essential to help prevent excessive profit situations from developing. In this regard, in a report to the Secretary of Defense (PSAD–79–38, March 8, 1979) we recommended, "Even though a portion of the profit rate might still be based on costs, the overall rate on (contractor) facilities investments should be computed to assist in identifying any potential excessive profit." This would not entail a great deal of effort since in October 1976, DOD changed its regulations to allow imputed interest on contractor facility investments as a reimbursable contract cost. Since that time, such contractor investment data has been developed by most contractors awarded major negotiated defense contracts.

To make our proposal viable, it would, of course, be essential to have in place the means of establishing fair and reasonable profits discussed under question one.

Questions Submitted by Senator Robert Morgan

GAO proposal

Senator Morgan. Let me ask a few questions about the suggestions you make for a fairer profit limitation system at the end of your statement. Why is it a good idea, as you suggest, to limit any profit limitation legislation to prime and first tier subcontracts only?

Aren't there possibilities for excess profits below that level on a major contract?

You suggest that instead of a specific ceiling on profits, however defined, that

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we limit excess profits to a percentage of the going-in profit. Isn't that just as arbitrary in its way? Does your proposal involve calculating profits in the same way it is now done under Vinson-Trammell?

Mr. SHELEY. Our suggestion is to limit profit limitation application to prime and subcontracts exceeding a specified amount. We did not mean that the subcontractors affected would be limited to the first tier level only. Our experience indicates that excess profits can occur at other subcontract levels. Limiting profits to a percentage of the going-in profit would be arbitrary only in the selection of the particular percentage figure to be used. Otherwise, the merit of this method stems from relating the profit allowed in effect to the factors (such as risk and complexity) originally considered in arriving at the negotiated contract profit. On the other hand, if a poor job was done in the original contract negotiations and an excessive profit was allowed, it would not be corrected under our method. Our proposal would not treat all profits as excessive that exceed one or two fixed profit rates. Thus, it is quite different from the Vinson-Trammell Act.

Senator MORGAN. Mr. Flynn said sometimes there is a situation where the contractors have all the business they can handle, so they bid high. If you award on that basis, you pay a very high profit. But if you set an arbitrary lower profit figure, you won't get any bids in this situation. How do you cure this problem?

Mr. SHELEY. If you have the appearance of competition but all bids are unreasonably high, we believe the contracting officer should reject all bids and use the negotiated procurement method. The authority to reject all bids and negotiate has been retained at very high management levels in the Department of Defense, and obtaining approval to use it is a tedious procedure requiring extensive justification. We believe this authority should be more readly available to the contracting officer for use under appropriate circumstances. As you know, in the case of negotiated procurements when the contracting officer and contractor cannot agree on price, we are recommending that legislation be enacted to provide an independent third party with authority to establish fair and reasonable prices binding on the Government and the contractor. This authority along with the existing authority under the Title I of the Defense Production Act, which provides for mandatory contractor acceptance of defense contracts, should be enough to take care of the problem described.

Senator MORGAN. I want to ask you this question, finally. I am not sure if you are willing or are in a position to make a recommendation, but do you agree it would be unwise and administratively difficult to go back and compute profits for all contracts completed after September 30, 1976, as the act now requires? Some 3½ years have elapsed without regulations.

Mr. SHELEY. I believe you alluded to that earlier, and I think it would be difficult to do, particularly in the absence of ground rules in this 3½-year period. It can be done. It is a task that can be done, but it is a question of equity and a question of how much effort we want to spend in doing it.

Senator MORGAN. I think we dealt with it when I was asking questions earlier about the equity of it, the fairness of it, and the economics of it. Taking into consideration all of those factors, would it seem fair to you to suspend the application of Vinson-Trammell from the date it became operative until a reasonable date in the future, say, some time next year when the Congress would have time to consider it, or DOD, and the IRS would have time to agree on guidelines and ground rules?

Mr. SHELEY. I would not think I would be as amenable as Congressman McCloskey to his date. I would prefer to see the gap closed before that, as soon as possible.

Senator MORGAN. Looking at it as a practical matter, we have got this year—you have already heard us talk about the political conventions, balancing the budget, dealing with inflation, cutting the in-

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crease in defense expenditures. When we come back in January, we have the first budget resolution.

Would it seem March 1 would be too early, or would July 1 be a more realistic date?

Mr. SHELEY. I would strive for the earliest date. You have asked for my opinion, and I have given you my opinion. I recognize the practicalities of the situation, and I think whatever date you impose will be difficult to accomplish. I would say March 31, if you could make it, would be a much more acceptable date than September 30.

Mr. FLYNN. Another possibility would be to have it applicable to contracts only over $5 million.

Mr. SHELEY. Temporary legislation.

Mr. FLYNN. Yes; most of these larger contractors are aware of the Vinson-Trammell Act. It is strictly on a percentage of the contract price, so it should not be too difficult for larger companies to figure what their profit was, and it wouldn't really be something new, because they are already subject to the law, even though it has not as yet been enforced.

Senator MORGAN. I have been told by a number of companies that the alternatives are now footnoted into their annual reports as to contingent liabilities under the Vinson-Trammell Act. Is that a reasonable accounting? Would it be a reasonable practice?

Mr. SHELEY. As a CPA, I would say I would be negligent if I would not do that. I think it fair and reasonable they do that, because of the uncertainties existing right now.

Senator MORGAN. Thank you, gentlemen.

Mr. SHELEY. Thank you, sir.

Senator MORGAN. I understand Congressman Grassley will not appear, but he has submitted a statement. We will make it a part of the record.

[The prepared statement of Congressman Grassley, from the State of Iowa, follows:]

PREPARED STATEMENT BY HON. CHARLES E. GRASSLEY

Mr. Chairman, thank you for allowing me the opportunity to testify this afternoon. As the former ranking minority member of the Banking Committee's Renegotiation Subcommittee, I have become familiar with the provisions of the Vinson-Trammell Act. I submit that this Act like the Renegotiation Board would provide a severe disincentive for the effective and efficient performance of negotiated contracts.

The government employs over 57,000 people who receive over a billion dollars, in salaries. Their sole purpose in life is to see to it that the government receives the most bang for its buck. This requires careful negotiation of the contract and diligent oversight of contract performance. If reforms are to be made, let them be made by re-educating these 57,000 souls to do the job they are paid to do.

The IRS was not set up to monitor defense contacts—that is the job of the Defense Department. Let the 10,000 auditors of the Defense Contract Audit Agency or the Inspectors General of the various branches be responsible for protecting the taxpayers' money. It's time to stop creating new agencies to, in effect, subsidize and encourage sloppy work.

The Vinson-Trammell Act should be repealed immediately so that the Defense Department can get on with the job. If the current system does not prevent certain types of contractors from receiving high profits, then the negotiation and monitoring process should be revised to accomplish fair, effective and efficient contracts with strict enforcement.

This problem cannot be solved by creating another "band-aid" agency which forces defense contractors to spend millions of taxpayers' dollars in burdensome

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paperwork requirements. The Vinson-Trammell Act only compounds the problem of contractors' reluctance to compete for defense contracts. The net result is less competition and higher bids.

Hopefully, this Congress can learn from the mistakes made by the burdensome Renegotiation Board. The Board's 200 employees could not monitor the millions of contracts any more than one of the proposed substitute agencies could with triple the number of employees. The solution to the problem of excess profits does not lie with after-the-fact determinations but rather a comprehensive system of contract negotiation with rewards and punishments if you will.

Thank you, Mr. Chairman.

Senator MORGAN. Our next witness is Mr. Theodore M. Kostos.

Mr. Kostos, we welcome you. If you would, please identify those accompanying you today.

STATEMENT OF THEODORE M. KOSTOS, ABA PUBLIC CONTRACT LAW SECTION, ACCOMPANIED BY DAVID L. HIRSCH AND O. S. HIESTAND

Mr. KOSTOS. My name is Theodore Kostos. With me are Mr. David Hirsch and Mr. Sparks Hiestand.

The American Bar Association appreciates this opportunity to present this statement on the Vinson-Trammell Naval Parity Act of 1934 which, as you know, limits profits on contracts and subcontracts for complete naval vessels and parts thereof to 10 percent, and for complete military aircraft and parts thereof to 12 percent of the final contract price.

I am chairman of the ABA public contract law section, and I have been authorized to present the ABA's views on this important legislation.

As I mentioned, with me today is Mr. Hirsch, senior corporate counsel for Norris Industries, Inc. He is also a council member of our section. With me also is Mr. Sparks Hiestand, of the law firm of Morgan, Lewis, and Bockius, who is chairman-elect of the section.

The views presented to you today are a distillation of an effort that has spanned 6 years and includes the input of large numbers of attorneys who practice in the field of public contract law.

This last February, the house of delegates of the ABA adopted the following resolution:

Be it resolved, That the American Bar Association favors the elimination of the profit limitation provisions of the Vinson-Trammell Act, and does not favor the adoption of any similar authority for profit limitation during peacetime.

The 1980 resolution passed by the house of delegates of the association is part of a continuation of positions taken by the house of delegates since 1974 and is consistent with the position taken by the house of delegates in August 1978 through which the ABA urged:

* * * the Congress of the United States not to renew the Renegotiation Act nor to provide any new similar authority for renegotiation during peacetime.

Since many other witnesses who have gone before us have advised your subcommittee of the reasons in favor of either repealing or amending the 46-year-old statute, we thought that it would be significant today to advise you of some very early history regarding reasons for repeal and to suggest reasons why there is no need for any similar authority to limit profit during peacetime.

Let me start with paragraph 1, Early Efforts to Repeal the Vinson-Trammell Act. As you know, Congress has kept the act in a suspended status for all but 9 of its last 46 years.

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One of the most recent reviews by the Congress, pursuant to Public Law 86–89, as amended, was a study by the Joint Committee on Internal Revenue Taxation which made a "full and complete study" of the Renegotiation Act of 1951. That report states:

The consensus among those who have directed themselves to this question is the the Vinson-Trammell and Merchant Marine Act provisions are not a desirable form of profit limitation.

Perhaps the most important considerations cited in support of this position are these.

One: They impair contractors' incentives to efficiency and tend to bring about a cost plus percentage of cost type of contracting, with resulting increases in the price paid by the Government for its procurements;

Two: That they deter contractors subject to their provisions from entering into Government contracts;

Three: That they are discriminatory in that they apply only to a few of the many types of contractors engaged in Government contracting; and

Four: That any such uniform, flat rate profit limitations are too arbitrary and inflexible in that they do not take into account various factors which must necessarily be taken into account in determining proper levels of profit.

The early history of repeal: Of even greater interest is that in November 1945, Congressman Carl Vinson, chairman of the House Naval Affairs Committee and father of the Vinson-Trammell Act, introduced a bill, H.R. 4622, to repeal the profit limitations provisions of the Vinson-Trammell Act.

This bill was favorably supported by reports from the War. Navy, and Treasury Departments but failed to receive any extensive consideration by the 79th Congress.

Subsequently, a new bill, H.R. 3051, was introduced in the 80th Congress at the specific request of the Department of Navy, providing for the repeal of the Vinson-Trammell Act profit provisions. This bill was favorably reported by the House Armed Services Committee unanimously on June 20, 1947, and was promptly passed by the House of Representatives.

It was also favorably reported unanimously from the Senate, Committee on Armed Services on June 19, 1947, but was lost, much to all of our dismay here today, in the logjam of legislation at the end of that session of the Congress. A year later, the enactment of the Renegotiation Act in 1948 had the effect of making any further consideration of the repeal bill at that particular time entirely unnecessary because the area of application to the Vinson-Trammell Act, profit limitation clause, had been almost entirely eliminated.

Enactment of legislation repealing the Vinson-Trammell Act provisions became of almost academic interest and no final congressional action was taken on the bill.

It is interesting to note in passing that a companion statute, section 505(b) of the Merchant Marine Act, calling for a similar 10 percent profit limitation for the construction of merchant vessels was repealed by the Merchant Marine Act of 1970, without any fanfare or hoopla.

We have attached portions of letters to our statement urging re-

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peal from Robert P. Patterson, Secretary of War, to the chairman of the Committee on Armed Services of the House of Representatives, dated May 27, 1947, and from Secretary John L. Sullivan, Acting Secretary of the Navy, to the Speaker of the House of Representatives dated March 20, 1947.

These references from what you might call antiquity are of considerable interest. The Honorable John L. Sullivan, Acting Secretary of the Navy, states:

> Further, because the act has narrowed competition very materially by discouraging contractors from dealing with the Navy, it may well be that the net result has been to increase costs to the Navy.

In an earlier paragraph, Mr. Sullivan states:

> Of the greatest concern to the Navy Department is the danger that if the profit-limitation provisions of the Vinson-Trammell Act are retained there will be serious interference with peace-time procurement.

Secretary Robert P. Patterson, whom we all admired, made this statement:

> It is the opinion of the War Department that close pricing and restriction of profits to reasonable amounts can best be achieved under a negotiated contract by the utilization of this acquired pricing experience. Furthermore, the interests of the Government would be adquately protected by the use of price redetermination clauses authorized by this law in such contracts, to assure that no undue profit would be realized by the contractors involved.

The reference to "this law" in the above paragraph relates to the Armed Service Procurement Act of 1947.

It is of considerable significance that price redetermination clauses authorized by the Armed Services Procurement Act of 1947 and considered by Secretary Patterson as significant tools for profit limitation are still available to the Department of Defense in 1980.

The infirmities of the 1934 Vinson-Trammell Act, particularly in peacetime, were obviously apparent in 1947 to both the War and Navy Departments, and, of course, to Representative Carl Vinson himself. Were it not for the intervention of the Renegotiation Act of 1948 with the suspension of the Vinson-Trammell Act, the 46-year-old statute would long since have been repealed.

There is no need for profit limitation during peacetime. It is well known that the various profit limitations statutes have been passed by the Congress either in times of preparation for war or during a declared war. In the event of a national emergency, there is never enough time to properly award the large numbers of Government contracts to private industry using the various legislative and regulatory tools which we call "good procurement practice."

During peacetime when there is adequate time to properly award contracts to private industry, the need for legislation to limit profits, as is found in the public utilities industry, is certainly not evident. In the public utilities industry, profit is not only limited but it is also guaranteed. In defense contracting and public contracting in general, profits certainly are not guaranteed to contractors by the U.S. Government.

As you are aware, there has been testimony suggesting there may be a need for profit limitation legislation in connection with sole source contracts. In our view, such a need has not been demonstrated,

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and a decision to impose profit limitation with respect to noncompetitive awards would be counterproductive.

The existence of such a limitation could lessen the efforts to improve competition and lead to more use of "sole source" awards.

In our view, there are adequate techniques and contracting methods to protect against any significant excessive profits under sole source contracts.

As already explained by others to this subcommittee, Public Law 87–653, the Truth in Negotiations Act, requires the contractor to provide complete, accurate, and current factual information to the Government negotiator, and subjects the contractor to a price reduction and other penalties if such information is "defective."

In addition, DOD sole source contracts are negotiated after a thorough and complete audit is performed by the Defense Contract Audit Agency. Quite often the audit agency has a recorded history of performance by the same contractor manufacturing the same product over time.

As well as audit assistance, the contractor negotiator has the assistance of technical experts from the various agencies which can advise him on the technical aspects of the contract. The negotiator is also assisted by a price analyst from his own agency who will review the materials produced by his technical experts and by the Defense Contract Audit Agency in order to provide the contract negotiator with the best information regarding price and profit before the negotiations commence with the contractor.

When DOD or any agency is faced with a need to make an initial award on a noncompetitive basis, there are techniques that can be used to eliminate the possibility of excessive profit. Defense acquisition regulations, now commonly called DAR, provide the following techniques which can be used by a contract negotiator when he or she suspects that there may be excessive profits earned in a specific sole source award.

One: A letter contract can be awarded. The contract is first awarded, with or without a ceiling, and the price and terms are negotiated later after complete audit. If the contractor and the Government are unable to agree on the price, then the price disagreement becomes a dispute which is heard by the Armed Services Board of Contract Appeals or the Court of Claims and the price is established by a judge. It should be pointed out that the contractor is usually well into production on the contract before the price is ever finalized.

Two: You can have a price redetermination clause. The DAR provides a number of clauses which can be inserted in a contract which require that the entire contract be repriced. At that point any excessive profit can be eliminated by the Department of Defense and if there is a disagreement, again the disagreement can be handled under the disputes clause of the contract before the Armed Services Board of Contract Appeals or the Court of Claims.

It should be noted that we previously indicated that Secretary Patterson stated to the House of Representatives on May 27, 1947, that price redetermination clauses would assure the Government that no undue profit would be realized by contractors involved. We realize that these clauses have been little used since the Korean war but clearly

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they are available for use in the rare situations where the Government believes that excessive profits might be earned on a negotiated sole source award.

Three: Fixed price incentive contracts. The Government has used numerous types of fixed price incentive contracts where ceilings are set on the total value of the contract and the Government and the contractor share any reduction in costs or any increase in costs. These fixed price incentive contracts have even included specific limitations on the amount of profit that a contractor can earn.

Four: Cost-type contracts. If all else fails, then the contract negotiator can always award a cost-type contract with a fixed fee. The amount of the profit need never be increased once the negotiated fee is fixed. As you know, the maximum fee permitted to be negotiated is already fixed by statute.

There is a statute that provides the minimum fees of 15 percent of the estimated cost of the contract, not including new fees for R. & D. contracts, 6 percent for architectural or engineering services, and 10 percent for all other costs plus fixed fee contracts.

A profit limitation provision enacted by Congress, we believe, would be a disincentive to the Government contract negotiators and their staff when attempting to negotiate the best price for the Government. The negotiators could always fall back on whatever limitations the Congress has determined to be required and use the legislation as a crutch rather than use good business judgment and the various procurement methods available to negotiate the best possible price for the government.

The ABA urges this subcommittee not to recommend new profit limitation legislation where there is no evidence that legislation is required.

Thank you, Mr. Chairman, for this opportunity to present the position of the ABA. We will be glad to discuss any questions.

Senator MORGAN. Thank you, gentlemen.

Gentlemen, how many lawyers make up the section of public contract law of ABA?

Mr. KOSTOS. Three thousand, of whom approximately half, I would guess, are Government lawyers and the others are not Government lawyers.

Senator MORGAN. How did the committee arrive at this position?

Mr. KOSTOS. By an analysis and review of the subject at council meetings, section meetings. We finally developed a sectionwide approach. We then presented that sectionwide approach to the house of delegates of the American Bar Association. The house debated the question and came forward with the resolution I read to you.

Senator MORGAN. Are you talking about a council meeting of the section of public contract law?

Mr. KOSTOS. Yes, starting with that, section meetings of the section, and then going right up to the American Bar Association.

Senator MORGAN. How many members are on the council?

Mr. KOSTOS. We have 15 voting members on the council.

Senator MORGAN. Could you furnish us with the names of those?

Mr. KOSTOS. I would be delighted to, sir.

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Senator MORGAN. Do you know how many of those are public contract attorneys?

Mr. KOSTOS. Do you mean Government attorneys?

Senator MORGAN. Yes.

Mr. KOSTOS. We could make that determination.

[The information follows:]

American Bar Association, Section of Public Contract Law:

Theodore M. Kostos, Chairman
O. S. Hiestand, Chairman-Elect
Thomas E. Abernathy IV, Secretary
Marshall J. Doke, Jr., Section Delegate
George M. Coburn and Allan J. Joseph, Immediate and Previous Past Chairmen

Council Members on the Section of Public Contract Law, American Bar Association:

*Ruth C. Burg	*Austin G. Roe
Roger N. Boyd	Thomas B. Treacy
David L. Hirsch III	Carl L. Vacketta
*S. Neil Hosenball	Robert D. Wallick
James J. Myers	

*An asterisk identifies the members that are government attorneys.

Senator MORGAN. Are you a Government attorney?

Mr. KOSTOS. I am a private practitioner, not involved with ships or planes.

Senator MORGAN. Do you represent any Government contracts?

Mr. KOSTOS. Yes; I have had Government contract claims. I am a private practitioner.

Senator MORGAN. Mr. Hirsch, what do you practice?

Mr. HIRSCH. I am a corporate lawyer.

Senator MORGAN. Do you represent contractors doing business with the Defense Department?

Mr. HIRSCH. I do. One.

Senator MORGAN. Oh. You said you are a lawyer for corporations?

Mr. HIRSCH. Yes.

Senator MORGAN. Which one?

Mr. HIRSCH. Norris Industries.

Senator MORGAN. What business are they in?

Mr. HIRSCH. We make commercial products and products for the Government.

Senator MORGAN. I am sorry, I didn't get your name.

Mr. HIESTAND. My name is Hiestand, sir.

Senator MORGAN. Where do you practice?

Mr. HIESTAND. I am now in private practice with Morgan, Lewis, Bockius. I did a tour of about 30 years with the Federal Government as a lawyer with the Atomic Energy Commission, and I served as the General Counsel on the Commission on Government Procurement.

Senator MORGAN. Does your law firm now represent Government contractors?

Mr. HIESTAND. Yes, sir, we do.

Senator MORGAN. All of you do, then?

Mr. HIESTAND. Yes, sir.

Senator MORGAN. You say this resolution was taken up by the American Bar house of delegates. How long was it debated?

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Mr. KOSTOS. Do you mean how long in time?

Senator MORGAN. Yes.

Mr. KOSTOS. It has been debated over a period of time, actually, several years. The item has been debated along with the Renegotiation Act, and the actual time of debate before the house of delegates, I imagine, would have been very short. They move fairly quickly.

Senator MORGAN. The house of delegates' adoption of this report was almost perfunctary based upon the recommendations of the section of public contract law.

Mr. KOSTOS. And based upon an analysis made by the house of delegates of the board of governors.

Senator MORGAN. Does the board of governors make an analysis of it in addition to the council?

Mr. KOSTOS. The liaison representative between the section and the bar generally, the ABA house of delegates and the Government, that liaison representative speaks for us before the house of delegates on the merits of any matter we present, and he would have analyzed it and as a member of the board of governors would have presented his views to the house of delegates.

Senator MORGAN. Is he a full-time employee of the American Bar?

Mr. KOSTOS. No, sir. They are outstanding lawyers at the bar with private practices.

Senator MORGAN. You don't know particularly who he was?

Mr. KOSTOS. Yes, sir.

Senator MORGAN. Who was he?

Mr. KOSTOS. Mr. Jenner of Chicago.

Senator MORGAN. Is he engaged in private practice?

Mr. KOSTOS. Yes, indeed. He is an outstanding trial lawyer. I don't think he is a practitioner in the field of public contracts.

Senator MORGAN. Thank you very much, gentlemen. Your entire statement will be inserted into the record.

[The statement follows:]

PREPARED STATEMENT OF THEODORE M. KOSTOS, CHAIRMAN, SECTION OF PUBLIC CONTRACT LAW, AMERICAN BAR ASSOCIATION

Mr. Chairman and Members of the Subcommittee: The American Bar Association appreciates this opportunity to present this statement on the Vinson-Trammell Naval Parity Act of 1934 (Public Law 73-135, 48 Stat. 505, as amended) (1934) which limits profits on contracts and subcontracts for complete naval vessels (and parts thereof) to 10 percent, and for complete military aircraft (and part thereof) to 12 percent, of the final contract prices.

I am Theodore M. Kostos, Chairman of the ABA's Public Contract Law Section, and I have been authorized to present the ABA's views on this important legislation.

With me today are David L. Hirsch, Senior Corporation Counsel of Norris Industries, Inc., who is a Council Member of the Section, and O. S. Hiestand of the law firm of Morgan, Lewis & Bockius, who is Chairman Elect of the Section.

The views presented to you today are a distillation of an effort that has spanned 6 years and includes the input of large numbers of attorneys who pracice in the field of public contract law.

This last February, the House of Delegates of the ABA adopted the following resolution:

> *Be it resolved*, That the American Bar Association favors the elimination of the profit limitation provisions of the Vinson-Trammell Act, and does not favor the adoption of any similar authority for profit limitation during peacetime.

The 1980 resolution passed by the House of Delegates of the Association is *part of a continuation* of positions taken by the House of Delegates since 1974.

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and is consistent with the position taken by the House of Delegates in August of 1978 through which the ABA urged ". . . the Congress of the United States not to renew the Renegotiation Act nor to provide any new similar authority for renegotiation during peacetime."

Since many other witnesses who have gone before us have advised your Subcommittee of the reasons in favor of either repealing or amending the 46-year old statute, we thought that it would be significant today to advise you of some very early history regarding reasons for repeal and to suggest reasons why there is no need for any similar authority to limit profit during peacetime.

I

EARLY EFFORTS TO REPEAL THE VINSON-TRAMMELL ACT

As you know, Congress has kept the Act in a suspended status for all but 9 of the last 46 years.

1. *One of the more recent reviews by the Congress.* Pursuant to Public Law 86–89, as amended, the Joint Committee on Internal Revenue Taxation made a "full and complete study" of the Renegotiation Act of 1951, as amended (H. Doc. No. 322, 87th Cong., 2d Sess.). That report states:

> *The consensus among those who have directed themselves to this question is that the Vinson-Trammell and Merchant Marine Act provisions are not a desirable form of profit limitation.*

Perhaps the most important considerations cited in support of this position are that:

(1) They impair contractors' incentives to efficiency and tend to bring about a cost-plus-percentage-of-cost type of contracting, with resulting increases in the price paid by the Government for its procurements;

(2) That they deter contractors subject to their provisions from entering into Government contracts;

(3) That they are discriminatory in that they apply only to a few of the many types of contractors engaged in Government contracting; and

(4) That any such uniform, flat rate profit limitations are too arbitrary and inflexible in that they do not take into account various factors which must necessarily be taken into account in determining proper levels of profit. (p. 46). (Emphasis added.)

2. *The early history of repeal.* Of even greater interest is that in November, 1945, Congressman Carl Vinson, Chairman of the House Naval Affairs Committee and father of the Vinson-Trammell Act, introduced a Bill, H.R. 4622, to repeal the profit limitations provisions of the Vinson-Trammell Act. This bill was favorably supported by reports from the War, Navy and Treasury Departments but failed to receive any extensive consideration by the 79th Congress.

Subsequently, a new Bill, H.R. 3051, was introduced in the 80th Congress at the specific request of the Department of Navy, providing for the repeal of the Vinson-Trammell Act profit provisions. This Bill was favorably reported by the House Armed Services Committee unanimously on June 20, 1947, and was promptly passed by the House of Representatives. It was also favorably reported unanimously from the Senate Committee on Armed Services on June 19, 1947, but was lost, much to all of our dismay here today, in the logjam of legislation at the end of that session of the Congress. A year later, the enactment of the Renegotiation Act in 1948 had the effect of making any further consideration of the Repeal Bill, H.R. 3051, at that particular time, entirely unnecessary because the area of application to the Vinson-Trammell Act, profit limitation clause, had been almost entirely eliminated. Enactment of legislation repealing the Vinson-Trammell Act provisions became of almost academic interest and no final Congressional action was taken on the Bill H.R. 3051.

It is interesting to note in passing that a companion statute, Section 505(b) of the Merchant Marine Act, calling for a similar 10% profit limitation for the construction of merchant vessels was repealed by the Merchant Marine Act of 1970. Public Law 91–469, 84 Stat. 1018, without much fanfare or hoopla.

We have attached portions of letters urging repeal from Robert P. Patterson, Secretary of War to the Chairman of the Committee on Armed Services of the House of Representatives, dated May 27, 1947, and from John L. Sullivan, Acting Secretary of the Navy, to the Speaker of the House of Representatives dated March 20, 1947.

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These references from antiquity are of considerable interest. The Honorable John L. Sullivan, Acting Secretary of the Navy, states in his letter of March 20, 1947:

> The difficulties created by the Vinson-Trammell Act are by no means offset by any real limitation on profits as a result. As of the beginning of last year, less than $8 million excess profits were recaptured under the act, although $131 million of alleged costs were in fact disallowed by the Compensation Board. Further, because the act has narrowed competition very materially by discouraging contractors from dealing with the Navy, it may well be that the net result has been to increase costs to the Navy.

In an earlier paragraph, Mr. Sullivan states:

> Of the greatest concern to the Navy Department is the danger that if the profit-limitation provisions of the Vinson-Trammell Act are retained there will be serious interference with peace-time procurement.

The Honorable Robert P. Patterson, Secretary of War, advised the Armed Services Committee of the House of Representatives in his May 27, 1947 letter that:

> It is the opinion of the War Department that close pricing and restruction of profits to reasonable amounts can best be achieved under a negotiated contract by the utilization of this acquired pricing experience. Furthermore, the interests of the Government would be adequately protected by the use of price redetermination clauses authorized by *this law* in such contracts, to assure that no undue profit would be realized by the contractors involved. [Emphasis added.]

The reference to ". . . this law . . ." in the above-mentioned paragraph deals with H.R. 1366 which became the Armed Services Procurement Act of 1947, 10 U.S.C. 2301 through 2314. It is of considerable significance that price redetermination clauses authorized by the Armed Services Procurement Act of 1947 and considered by Secrtary Robert P. Patterson as significant tools for profit limitation, are still available to the Department of Defense in 1980.

The infirmities of the 1934 Vinson-Trammell Act, particularly in peace time, were obviously apparent in 1947 to both the War and Navy Departments and, of course, to Representative Carl Vinson himself. Were it not for the intervention of the Renegotiation Act of 1948 with the suspension of the Vinson-Trammell Act, the 46-year old statute would long since have been repealed.

II

THERE IS NO NEED FOR PROFIT LIMITATION DURING PEACETIME

It is well known that the various profit limitations statutes have been passed by the Congress either in times of preparation for war or during a declared war. In the event of a national emergency, there is never time enough to properly award the large numbers of Government contracts to private industry using the various legislative and regulatory tools which we call "good procurement practice".

During peace time when there is adequate time to properly award contracts to private industry, the need for legislation to limit profits, as is found in the public utilities industry, is certainly not evident. In the public utilities industries, profit is not only limited but it is also guaranteed. In defense contracting and public contracting in general profits certainly are not guaranteed to contractors by the United States Government.

As you are aware, there has been testimony suggesting there may be a need for profit limitation legislation in connection with "sole source" contracts. In our view such a need has not been demonstrated, and a decision to impose profit limitation with respect to non-competitive awards would be counter productive. The existence of such a limitation could lessen the efforts to improve competition and lead to more use of "sole source" awards.

In our view there are adequate techniques and contracting methods to protect against any significant excessive profits under sole source contracts.

As already explained by others to this Subcommittee, Public Law 87-653 entitled "Truth in Negotiations" requires the contractor to provide complete,

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accurate and current factual information to the Government negotiator; and subjects the contractor to a prior reduction and other penalties if such information is "defective." In addition, DOD sole source contracts are negotiated after a thorough and complete audit is performed by the Defense Contract Audit Agency. Quite often the audit agency has a recorded history of performance by the same contractor manufacturing the same product over time. As well as audit assistance, the contract negotiator has the assistance of technical experts from the various agencies which can advise him on the technical aspects of the contract. The negotiator is also assisted by a price analyst from his own agency who will review the materials produced by his technical experts and by the Defense Contract Audit Agency in order to provide the contract negotiator with the best information regarding price and profit before the negotiations commence with the contractor.

When DOD, or any agency, is faced with a need to make an initial award on a non-competitive basis, there are techniques that can be used to eliminate the possibility of excessive profit. Defense Acquisition Regulations (DAR) provide the following techniques which can be used by a contract negotiator when he or she suspects that there may be excessive profits earned in a specific sole source award.

1. *A letter contract can be awarded.* The contract is first awarded, with or without a ceiling, and the price and terms are negotiated later after complete audit. If the contractor and the Government are unable to agree on the price then the price disagreement becomes a dispute which is heard by the Armed Services Board of Contract Appeals or the Court of Claims and the price is established by a judge. It should be pointed out that the contractor is usually well into production on the contract before the price is ever established.

2. *Price redetermination clauses.* The DAR provides a number of clauses which can be inserted in a contract which require that the entire contract be repriced. At that point, any excessive profit can be eliminated by the Department of Defense and if there is a disagreement, again the disagreement can be handled under the Disputes Clause of the contract before the Armed Services Board of Contract Appeals or the Court of Claims.

It should be noted that we previously indicated that Mr. Robert P. Patterson, Secretary of War, stated to the Chairman of the House Armed Services Committee of the House of Representatives on May 27, 1947 that price redetermination clauses would assure the Government that no undue profit would be realized by contractors involved. We realize that these clauses have been little used since the Korean War but clearly they are available for use in the rare situations where the Government believes that excessive profits might be earned on a negotiated sole source award.

3. *Fixed price incentive contracts.* The Government has used numerous types of fixed price incentive contracts where ceilings are set on the total value of the contract and the Government and the contractor share any reduction in costs or any increase in costs. These fixed price incentive contracts have even included specific limitations on the amount of profit that a contractor can earn.

4. *Cost-type contracts.* If all else fails, then the contract negotiator can always award a cost-type contract with a *fixed* fee. The amount of the profit need never be increased once the negotiated fee is fixed. As you know, the maximum fee permitted to be negotiated is already fixed by statute.[1]

A profit limitation provision enacted by Congress, we believe, would be a disincentive to the Government contract negotiators and their staff when attempting to negotiate the best price for the Government. The negotiators could always fall back on whatever limitations the Congress has determined to be required and use the legislation as a crutch rather than use good business judgment and the various procurement methods available to negotiate the best possible price for the Government.

The ABA urges this Subcommittee not to recommend new profit limitation legislation where there is no evidence that legislation is required.

Thank you, Mr. Chairman, for this opportunity to present the position of the ABA. We will be glad to discuss any questions you may have now or with the Subcommittee Staff at a later date.

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[1] 10 U.S.C. 2306(d). The maximum fees are fifteen percent (15%) of the estimated cost of the contract, not including fees, for research and development contracts, six percent (6%) for architectural or engineering services and ten percent (10%) for all other cost-plus-a-fixed fee contracts.

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WAR DEPARTMENT,
Washington, D.C., May 27, 1947.

Hon. WALTER G. ANDREWS,
Chairman, Committee on Armed Services,
House of Representatives.
Washington, D.C.

DEAR MR. ANDREWS: The War Department favors the enactment of H.R. 3051, a bill to amend the act of July 19, 1940 (54 Stat. 780, 34 U.S.C. 495a), and to amend section 2 and to repeal the profit-limitation and certain other limiting provisions of the act of March 27, 1934 (48 Stat. 503, 34 U.S.C. 495), as amended, relating to the construction of vessels and aircraft, known as the Vinson-Trammell Act, and for other purposes.

The War Department is particularly concerned with the repeal of the profit-limitation provisions contained in the Vinson-Trammell Act, which provisions were made applicable to Army aircraft by section 14 of the act of April 3, 1939.

* * * * * * *

The percentage of profit allowed under the act is based on actual costs. This type of arrangement has inherent in it all of the evils of the cost-plus-a-percentage-of-cost type contract. It places no premium on efficient and economic production.

The profit-limitation provisions of the act single out two industries, shipbuilding and aircraft, as the subject of special restrictions. While the prime contractors in these fields might have no choice but to accept these restrictions, it is likely that many of their potential subcontractors (to whom the same profit limitations would apply under the act) would have a choice and would decide to produce materials or render services for other industries to which these profit limitations did not apply.

At the time this legislation limiting profits was made applicable to aircraft procured by the War Department, a program for the acquisition of quantities of aircraft far exceeding those theretofore authorized at any one time was in contemplation. In addition, the current technique of price analysis and of pricing on behalf of the War Department had not developed to its present stage and legislation at that time was considered essential for the purpose of protecting the Government against the payment of inflated prices for aircraft. During the past 5 years, however, pricing experience in connection with negotiated contracts on the part of Government personnel has been attained to a considerable degree. Assuming that H.R. 1366, the Army-Navy procurement bill, which has already passed the House of Representatives, is enacted into law, it is likely that many contracts for the construction of aircraft will be negotiated under this law. It is the opinion of the War Department that close pricing and restriction of profits to reasonable amounts can best be achieved under a negotiated contract by the utilization of this acquired pricing experience. Furthermore, the interests of the Government would be adequately protected by the use of price predetermination clauses authorized by this law in such contracts, to assure that no undue profit would be realized by the contractors involved.

* * * * * * *

Sincerely yours,

(Signed) ROBERT P. PATTERSON,
Secretary of War.

NAVY DEPARTMENT,
Washington, D.C., March 20, 1947.

Hon. JOSEPH W. MARTIN, Jr.,
Speaker of the House of Representatives,
Washington, D.C.

MY DEAR MR. SPEAKER: There is transmitted herewith a draft of a proposed bill to amend the act of July 19, 1940 (54 Stat. 780, 34 U.S.C. 495a), and to amend section 2 and to repeal the profit-limitation and certain other limiting provisions of the act of March 27, 1934 (48 Stat. 503, 34 U.S.C. 495), as amended, relating to the construction of vessels and aircraft, known as the Vinson-Trammell Act, and for other purposes.

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It should be noted here that the existing profit-limitation provisions of the Vinson-Trammell Act apply only to ship-building and aircraft manufacturing

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industries. Manufacturing enterprises unrelated to these two industries are not subject to such limitations; hence, an unjustified discrimination against these two major industries exists. Moreover, rigorous enforcement of the profit limitations requires complicated and costly bookkeeping by contractors and subcontractors and the maintenance by the Government of a large additional number of auditors and examiners. Problems as to the commercial overhead necessitate an audit of all the commercial work performed by a contractor.

* * * * * * *

Of the greatest concern to the Navy Department is the danger that if the profit-limitation provisions of the Vinson-Trammell Act are retained there will be serious interference with peacetime procurement. The fact that the shipbuilding and aircraft manufacturing industries are singled out may tend to discourage producers from entering these two fields in the Navy's interest. The burden of bookkeeping thrust upon the contractor and subcontractor has, in the past, made them reluctant to enter into contracts or subcontracts with the Navy. This danger is especially acute in such fields as aeronautics and ship components where there is a large civilian outlet for such products and it is apparent that such contractors will prefer to deal exclusively in civilian fields which are free from the burdens of the profit-limitation provisions imposed by existing law.

It is particularly important to note that the profit-limitation provisions adopt a flat percentage limitation as the means of control. This is not an appropriate or successful technique for limiting profits as it takes no account of the amount of invested capital which must be carried by a particular contractor not of the fact that in different lines of business the same volume of sales may require widely different amounts of capital. A percentage limitation does not allow appropriate consideration to be given to the nature of the articles purchased, the difficulties of producing them, or the number bought. Control by a percentage of the contract price is dangerous because an allowable increase in the contract price provides a larger allowed net profit, so that the contractor and subcontractor are provided with statutory incentive to inflate the contract price. The June 1940 amendment to the Vinson-Trammell Act, provided a serious temptation for contractors and subcontractors to inflate both their contract price and their actual costs of performance. No stimulus was afforded such contractors for savings in costs, but under the June 1940 amendment, the contrary was true. In some respects, the profit-limitation provisions reduce all contracts to a cost-plus-percentage-of-cost basis—a mode of contracting long since recognized as undesirable.

* * * * * * *

The difficulties created by the Vinson-Trammell Act are by no means offset by any real limitation on profits as a result. As of the beginning of last year, less than $28 million excess profits were recaptured under the act, although $131 million of alleged costs were in fact disallowed by the Compensation Board. Further, because the act has narrowed competition very materially by discouraging contractors from dealing with the Navy, it may well be that the net result has been to increase costs to the Navy.

One of the aims of the Vinson-Trammell Act was to establish a yardstick for the aircraft industry at a time when that industry was undergoing tremendous expansion. The industry has now reached such a stage of competitive development and has acquired such knowledge concerning the costs involved, that the maintenance of a naval yardstick is no longer necessary. Competition between various private plants will tend to result in economy of Government procurement.

* * * * * * *

Sincerely yours,

JOHN L. SULLIVAN,
Acting Secretary of the Navy.

Senator MORGAN. Our next witness is Mr. William H. Smith, corporate director of contracts, Newport News Shipbuilding & Drydock Co., Newport News.

Would you identify for the record the gentleman accompanying you?

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STATEMENT OF WILLIAM H. SMITH, CORPORATE DIRECTOR OF CONTRACTS, NEWPORT NEWS SHIPBUILDING & DRYDOCK CO., NEWPORT NEWS, VA.; ACCOMPANIED BY CHARLES T. MICHAELIAN, ACCOUNTING, NEWPORT NEWS SHIPBUILDING & DRYDOCK CO.

Mr. SMITH. Mr. Chairman, I have with me Charles T. Michaelian, of Newport News Shipbuilding & Drydock Co.

Mr. Chairman, I am pleased to present the views of Newport News Shipbuilding on Senate bill 1687 and related legislation concerning profit limitations in defense contracting. I request that the entire presentation be admitted as part of the minutes and I will paraphrase.

Senator MORGAN. We will make your entire statement a part of the record. Feel free to proceed in any way you like.

[The prepared statement of Mr. Smith follows:]

PREPARED STATEMENT OF WILLIAM H. SMITH, NEWPORT NEWS SHIPBUILDING & DRYDOCK CO.

Mr. Chairman and members of the committee, my name is William H. Smith and I am the corporate director of contracts for Newport News Shipbuilding & Drydock Co.

I am pleased to present the views of Newport News Shipbuilding on Senate bill S. 1687 and related legislation concerning profit limitations in defense contracting.

Mr. Chairman, Newport News strongly advocates the repeal of the Vinson-Trammell Act. I will enumerate our reasons.

1. The Vinson-Trammell Act is the product of a different defense procurement era.

2. The act is limited in its application only to new naval vessels and military aircraft.

3. The need for profit limits on defense contracting during periods of peace has not been established.

4. Profit limits have a very negative effect on the defense industrial supply base.

5. Profit limits encourage inefficiency.

Let me expand on these.

Procurement conditions have greatly change since 1934.

A. The Government has full access to contractor cost data on all negotiated contracts over $100,000. If on audit, the cost data which was the basis of contract price is found deficient, the Government can recoup any resulting increase in the price (Public Law 87-653—Truth in Negotiations).

B. The Defense Contract Audit Agency (DCAA) performs pre-award and post-award audits covering the contractor's actual costs and effectiveness of overall management and operations. They in essence have the power to disallow and thereby not reimburse the contractor for costs considered by the DCAA as unreasonable.

C. Prior to contracting the contracting officer is required to file a detailed plan of the profit negotiations. The profits allowed are related to the audited cost estimates and other factors relative to the contractor's investment and risk.

D. Although cost accounting standards do not establish profit, their required use on major contracts by a contractor insures that the Government may recover increased costs if there is a deviation from the contractor's consistent application of his disclosed accounting practices.

E. All contracts in excess of $10,000, except those resulting from formal advertising, provide for examination of records by the controller general.

F. Government representatives are located at most large contractor facilities to insure proper fulfillment of contract terms and conditions.

G. Government representatives are better educated in contracting practices today.

The act is limited in its application to new naval vessels and military aircraft. It doesn't make sense to apply a profit limitation to just these two products and

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have no limitation on the vast amount of other defense and space procurement. That inequity, although unfair in itself, is compounded by permitting a higher profit for military aircraft than for naval ships.

The need for profit limitations on defense procurement in times of peace has not been proven. In fact, the necessity for profits as a motivator for effective and economical contract performance has been the cornerstone of the Department of Defense profit policy. Profits are the simplest and least expensive stimulus to efficiency, investment, competition and innovation. Arbitrary profit limits destroy this stimulus and, in the end, increase costs and reduce the industrial defense mobilization base by driving the efficient contractor away from defense business. The Joint Economic Committee in its 1980 annual report states "* * * steady economic growth * * * created by productivity gains and accompanied by a stable fiscal policy and a gradual reduction in the growth of the money supply over a period of years * * * can reduce inflation significantly during the 1980's without increasing unemployment. To achieve this goal, the committee recommends a comprehensive set of policies designed to enhance the productive side * * * the supply side of the economy." The productive side cannot be enhanced without suitable rewards for efficiency. Profits provide this reward.

Profit limitations have a detrimental effect on the defense industrial supply base.

Profits on new naval ship construction historically have been a great deal less than the Vinson-Trammell limit of 10 percent. Our concern, however, is for its impact on our suppliers and their profitability. It is the profitability of our suppliers that creates greater competition and that results ultimately in lower overall costs. Profits lure new competitors, new concepts and new capital by rewarding those who effectively use their resources. Our success depends on the success of our suppliers at any level. The harmful effects of Vinson-Trammell permeate to the lowest level subcontractor with a $10,000 limit.

Newport News must compete with a suppliers' commercial customers and other defense customers either not subject to the act or subject to a higher limit. A supplier may have a choice of selling a pump for a naval vessel at 10 percent profit or for a commercial tanker for a much greater profit and less administrative burden. If we are not able to secure the materials at the appropriate time for the orderly construction of a vessel, delays result that increase costs. If we are unable to purchase the necessary material because the supplier refuses to accept the Vinson-Trammell contract clause, the increased costs of finding and developing alternate sources of supply only add cost to the new ship, not improved capability. To burden our suppliers with additional paperwork and the threat of Internal Revenue Service audit can only work to the detriment of the naval ship construction program.

When you can earn in excess of 15 percent on certificates of deposits and other savings devices, it seems inappropriate to continue the 1934 limit of 10 percent.

Profit limits have historically rewarded the inefficient contractor while punishing the efficient one.

Newport News Shipbuilding has spent considerable time and effort on the proposed implementation of the Vinson-Trammell Act over the past 4 years. We conclude that the act is incapable of effective implementation and has no place in the current defense procurement process.

We support the repeal of the Vinson-Trammell Act and urge you to take early action before it adversely affects our sources of supply which are already overburdened with procurement regulations.

Alternative legislation to impose profit limits have been introduced. We cannot support these bills. The so-called Patterson Bill (H.R. 5433) suffers from much the same problems of the Vinson-Trammell Act, only applied to a greater range of articles for the national defense.

This bill has no statutory definition of profit but leaves that to the Department of Defense. Leaving this crucial definition to the regulating agency can result in limitations beyond those envisioned in the statute. For instance, using the defense acquisition regulations to measure the cost of contract performance would overstate profits by at least 2 percent because certain costs, although legitimate business expenses are not reimbursable for Government contracts.

The bill applies to noncompetitive contracts. There are a great many noncompetitive contracts that are negotiated only after considerable discussion between the contractor and the Government.

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Newport News is alloted submarine overhaul and nuclear refueling contracts by the Navy as part of the regular program for submarine readiness. We have been successful in underrunning the target costs and thereby realizing increased profits on some of these contracts. However, the total cost to the Navy has been less, excluding inflation, than the cost when the contracts were competitively bid. Newport News theoretically could earn 15 percent on these contracts, depending on the definition of profit, and, even though the Navy received a better value, be forced to refund some of the profit. By increasing the costs and overrunning the target, we would keep the entire price though the cost to the Navy would be higher. This is the insidious nature of profit limits which reward the contractor for cost overruns.

Contractors doing business with the Government under contracts of $5 million or more are usually repeat vendors to the Government. If in our example of the submarine overhaul and nuclear refueling contract, Newport News realizes a profit more than the Navy estimated, on the following contract the negotiations of target costs would be much more difficult for the contractor. This has been our experience. A higher profit realized by the contractor on one contract is usually made up on the next to the benefit of the Navy.

And most importantly, this bill also applies only to individual contracts without the benefit of offset. If one contract results in a loss and another contract in a profit in excess of 15 percent, the contractor must refund the excess even if the net of the two contracts is an overall loss.

The Naval ship construction contracts that we have negotiated, and some were sole source, have not indicated a problem with high profits. I cannot predict what shortages these profit limits will create in our supply sources, but it is unwise to apply widespread limits to all defense procurement if the source of the Department of Defense concern is with only a single or a few sole source suppliers. Repeal Vinson-Trammell. If a proven need arises, attack that problem.

One final thought. There are many burdens on Government contractors. Another bill currently in the Senate would make an inadvertent mistake in certification or reporting requirements the basis for civil fraud damages. Let's not add the Vinson-Trammell as a source for litigious actions.

Newport News is the only shipyard currently constructing nuclear-powered aircraft carriers and cruisers, and shares the submarine construction with one other shipyard. The record of the excellent performance of Newport News-built ships is unexcelled by any shipyard, private or Government owned.

Newport News will continue to serve this Nation by developing better, faster, more reliable and economical construction methods to supply outstanding ships to the U.S. Navy on a timely basis. But we will need legislative help to do it.

Again, we thank you for the opportunity to present our views and I will be pleased to answer any questions.

Mr. SMITH. Mr. Chairman, Newport News strongly advocates the repeal of the Vinson-Trammell Act. I will enumerate our reasons.

The Vinson-Trammell Act is the product of a different defense procurement era. The act is limited in its application only to naval vessels and military aircraft. The need for profit limits on defense contracting during periods of peace has not been established. Profit limits have a very negative effect on the defense industry supply base. Profit limits encourage inefficiency.

Let me expand on these. Procurement conditions have greatly changed since 1934. We have the Truth in Negotiations Act. We have preaward and postaward audits from the Defense Contract Audit Agency, and we have uniform cost accounting standards with which we must comply.

The act is limited in its application to naval vessels and military aircraft. It doesn't make sense to apply a profit limitation to just these two products and have no limitation on the vast amount of other defense and space procurement. That inequity, although unfair in itself, is compounded by permitting a higher profit on military aircraft than for naval ships.

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The need for profit limitations on defense procurement in times of peace has not been proven. In fact, the necessity for profits as a motivator for effective and economical contract performance has been the cornerstone of the Department of Defense profit policy.

Profits are the simplest and least expensive stimulus to efficiency, investment, competition, and innovation. Arbitrary profit limits destroy this stimulus and, in the end, increase cost and reduce the industrial defense mobilization base by driving the efficient contractor away from the defense business. Profit limitations have a detrimental effect on the defense industrial supply base. Profits on new naval ship construction historically have been a great deal less than the Vinson-Trammell limit of 10 percent.

Our concern, however, is for its impact on our suppliers and their profitability. It is the profitability of our suppliers that creates greater competition and that results ultimately in lower overall costs. Profits lure new competitors, new concepts, and new capital by rewarding those who effectively use their resources. Our success depends on the success of our suppliers at any level. The harmful effects of Vinson-Trammell permeate to the lowest level subcontractor with a $10,000 limit.

Profit limits have historically rewarded the inefficient contractor while punishing the efficient one. A specific example.

A few years ago we had competition in the overhaul and refueling of nuclear submarines. In a single announcement of contract award, our competitor received a contract for $50 million, 10-percent profit, Newport News, $30 million, 10-percent profit, the same margin, the same scope of work.

We support the repeal of the Vinson-Trammell Act, and urge you to take early action before it adversely affects our sources of supply which are already overburdened with procurement regulations. You may recall from the testimony from John Fluke Manufacturing Co., and I will quote, "In the event the Vinson-Trammell Act is fully implemented, we most assuredly will refuse such sales." John Fluke is a supplier to Newport News Shipbuilding, not only for the ships we construct but for the test programs and the calibration of instruments used in the manufacture of ships.

Alternative legislation to impose profit limits have been introduced. We cannot support these bills. The so-called Patterson bill suffers from much the same problems as the Vinson-Trammell Act, only applied to a greater range of articles for the national defense, at a limit which, we have already heard testimony, there is no evidence the larger contractors have exceeded, nor the current 10-percent limit of the Vinson-Trammell.

This bill has no statutory definition of profits, but leaves that to the Department of Defense.

Leaving this crucial definition to the regulating agency can result in limitations beyond those envisioned by the statute. For instance, using the defense acquisition regulations to measure the cost of contract performance would overstate profits by at least 2 percent because certain costs, although legitimate business expenses, are not reimbursable for Government contracts.

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Examples of those costs: Interest and financing costs; advertising and contributions.

The bill applies to noncompetitive contracts. There are a great many noncompetitive contracts that are negotiated based upon historical costs. In most contracts that are negotiated, much more time is spent on the cost of previous or similar products than the risk involved in the new procurement. Most importantly, this bill also applies only to individual contracts without the benefit of offset. If one contract results in a loss and another contract in a profit in excess of 15 percent, the contractor must refund the excess even if the net of the two contracts is an overall loss. The naval ship construction contracts which we have negotiated—and some were sole source—have not indicated a problem with high profits.

I cannot predict what shortages these profit limits will create in our supply sources, but it is unwise to apply widespread limits to all defense procurement, if the source of the Department of Defense concern is with only a few sole source suppliers. Repeal the Vinson-Trammell. If a proven need arises, attack that problem.

Newport News is the only shipyard currently constructing nuclear powered aircraft carriers and cruisers and shares the submarine construction with one other shipyard.

The record of the excellent performance of Newport News-built ships is unexcelled by any shipyard, private or Government owned. Newport News will continue to serve this Nation by developing better, faster, more reliable and economical construction methods to supply outstanding ships to the U.S. Navy on a timely basis, but we will need legislative help to do it.

Again, we thank you for the opportunity to present our views, and I will be pleased to respond to questions.

Senator MORGAN. I think you have answered most of the questions in your presentation, but for the record, will you tell us the types of ship Newport News has built during the last few years and whether or not they were competitive or sole source contracts?

Mr. SMITH. During the decade of the seventies, Newport News delivered 14 nuclear powered ships to the Navy, 7 submarines all bid competitively, 5 nuclear cruisers, and 2 aircraft carriers, sole source procurement.

Senator MORGAN. How many of those contracts, or at least how many of the more recent contracts were there, or on any of those contracts did you exceed the profit limitations now in the Vinson-Trammell Act?

Mr. SMITH. We did not exceed any of those profit limitations.

Senator MORGAN. You would be happy to build them at that profit level?

Mr. SMITH. We would be happy to build them at that level.

Senator MORGAN. How do you estimate the administrative cost of compliance with Vinson-Trammell?

Mr. SMITH. It would probably be the equivalent of two full-time analysts. The administrative costs on our suppliers would be tremendous, because Vinson-Trammell does not stop with the first tier subcontractor. If we had a special steel ingot produced by a steel mill

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that we brought into our foundry and it was made into finished products, we would have to determine whether the end product went on board a naval ship or commercial ship. It would be almost impossible to administer the Vinson-Trammell as written.

Senator MORGAN. One other question. I think you and I have already talked about it, and you have heard the discussions earlier about the legislative schedule this year and the difficulty of enacting final legislation. I assume you would favor suspension retroactive back to the date it became effective and just some reasonable time next year.

Mr. SMITH. The position of Newport News clearly, as I stated, is, we think the act should be repealed.

However, as you explained to me the difficulty in obtaining this repeal in the current session of Congress, we would support your proposal to suspend Vinson-Trammell to some time in the future.

Senator MORGAN. Thank you very much. I believe you have covered most of the questions I had in your statement, and we appreciate your coming and being patient. I will see you back home. I have a few questions from Senator Humphrey for you to answer for the record.

Mr. SMITH. Thank you. We will supply the answers to Senator Humphrey's questions.

[Questions submitted by Senator Humphrey follow:]

Senator HUMPHREY. It is my belief that if we were to leave Vinson-Trammell in place, the bureaucracy required to implement it would outweigh the benefits in terms of excess profits returned to the government. Do any of the proposals before the Congress in your judgment have enough benefit to outweigh the costs of the bureaucracy enforcing them, and your own industry's cost of complying?

Answer. I certainly agree that the implementation of Vinson-Trammell would be extremely costly to the defense of this country. As I testified, the fulfillment of our prime contractor responsibilities in timely construction and delivery of quality naval vessels depends on a strong base of suppliers. Profit limits of 10 percent on all supplies, even commercial articles, for more than $10,000 would force many of these vital suppliers to forego defense business. In fact, the John Fluke Co., who is one of our suppliers, expressed that warning to your subcommittee.

As to the alternatives now before Congress, the costs to the defense program would again outweigh any so-called benefits. First, there has been no proven need for profit limiting legislation in peacetime. The General Accounting Office suggests a profit limiting statute "that would become operative during a period of national emergency". The Department of Defense has not identified any negotiated contracts that indicated profits in excess of their suggested 15 percent limit. Second, there is no benefit to the United States in a shrinking defense industrial base. Applying broad profit limits costs the taxpayers in inflated costs of defense procurement by eliminating competition and subsidizing inefficient contractors. The opportunity for higher profits encourages greater competition, with the taxpayer being the ultimate beneficiary. I, therefore, believe that none of the proposals for profit limitations are beneficial to the taxpayers in peacetime but rather are exceedingly costly.

Senator HUMPHREY. Another argument for some limitation is that it would deter excess profits by the defense industry. In your judgment, would any benefit of deterrence value of any of these alternatives be worth the cost of enforcement and compliance?

Answer. In my judgment all profit limiting legislation in peacetime is unwarranted and harmful to the defense program. The low productivity today cries out for greater contractor efficiency. Profit rewards are incentives for efficient contractor performance and encourage greater productivity.

As I indicated in my statement, even though many of our contracts are negotiated sole-source, it is difficult to obtain even a reasonable profit in negotiations. The government has a built in profit deterrent in that most of the large defense contractors are repeat vendors. The government's use of historical cost, truth in

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negotiations, and audit before and after awards make it exceedingly unlikely to realize windfall profits. If the Department of Defense can identify recent major contracts where they had to pay high profits because of limited suppliers, then attack those incidents and do not burden all the defense community.

I appreciate your asking these questions. I am an ardent supporter of a strong defense industry providing the best weapons at reasonable costs to the taxpayers. It concerns me that the defense industry is singled out for limitations of profits that do not apply to other government procurement. Please let me know if I may be of further service.

Senator MORGAN. Mr. Paladino, the senior vice president and treasurer, Grumman Aerospace Corp.

STATEMENT OF CARL A. PALADINO, SENIOR VICE PRESIDENT AND TREASURER, GRUMMAN AEROSPACE CORP.

Mr. PALADINO. Mr. chairman and members of the subcommittee, I am Carl Paladino, senior vice president and treasurer of Grumman Aerospace Corp., a subsidiary of Grumman Corp., Bethpage, N.Y.

Grumman Aerospace Corp. is engaged principally in the design, development, and manufacture of military aircraft, commercial aircraft, and spacecraft.

I am pleased to be here to urge the repeal of the Vinson-Trammell Act of 1934. Thus, I fully support S. 1687, introduced by Senator Cranston and Senator Lugar in the 96th Congress to repeal this act which is now obsolete.

Since there has been considerable previous testimony on the background of the act, I will not cover that ground again. Rather, I will spell out the facts which call for the prompt repeal of Vinson-Trammell.

One: Government protective measures against excess profits are already in place. Since the end of the Second World War, the defense procurement system has undergone dramatic change. There has been an ever-increasing effectiveness through new legislation, organization, regulation, and analytical techniques. Principal legislative changes have been Public Law 87–653, Truth in Negotiations, and Public Law 91–379, Cost Accounting Standards.

Increases and changes in organization include the establishment of the Defense Contract Audit Agency—DCAA—the Defense Contract Administration Service—DCAS—and the service plant cognizance program. The Defense Acquisition Regulation, issued and continually updated by DOD, provides for guidance and regulations throughout the entire procurement process including actual incorporation of pertinent sections in contracts to suppliers.

Thus under present conditions where competition is not feasible, contractors must prepare their proposal in conformity with the way actual costs will be recorded, certify as to the accuracy, completeness, and currency of the price and pertinent data, submit to Government review, Government audit, and negotiation before the contract is awarded.

After the award is made, the Government, by virtue of Public Law 87–653, can come back and review all costs and all other related data. If the contractor's data was inaccurate, incomplete, or noncurrent, the Government is entitled to a refund. This ability of the Govern-

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ment to relook after contract award and performance and receive a refund is simply "Renegotiation" under a different name and law.

Senator MORGAN. Mr. Paladino, let me interrupt you just a moment there. You lost me and yet you struck an interesting note. Would you tell me again, are you saying that under the present law this can be done?

Mr. PALADINO. This is what is happening under present law today, sir.

Senator MORGAN. All right. Go ahead. I will read it later. It is an interesting point.

Mr. PALADINO. The capability of the Department of Defense to evaluate contractor proposals and to negotiate contract prices has, in fact, resulted overall in inadequate profits. This is clearly evidenced by numerous studies on defense industry profits. One specific DOD profit study called "Profit, '76," indicated an average pretax return on defense sales of 3.7 percent for aircraft and 0.6 percent for naval vessels.

The second reason for repeal is, further attempts to limit profits will be counterproductive. The emphasis on minimizing profits rather than costs will have the same adverse impact on defense production as the Renegotiation Act.

I believe this point can be best made by quoting from the DOD Defense Acquisition Regulation:

3-808.1 Policy. (a) General. It is the policy of the Department of Defense to utilize profit to stimulate efficient contract performance. Profit generally is the basic motive of business enterprise. The Government and defense contractors should be concerned with harnessing this motive to work for more effective and economical contract performance.

Negotiation of very low profits, the use of historical averages, or the automatic application of a predetermined percentage to the total estimated cost of a product does not provide the motivation to accomplish such performance. Furthermore, low average profit rates on defense contracts overall are detrimental to the public interest. Effective national defense in a free enterprise economy requires that the best industrial capabilities be attracted to defense contracts.

These capabilities will be driven away from the defense market if defense contracts are characterized by low profit opportunities. Consequently, negotiations aimed merely at reducing prices by reducing profits, with no realization of the function of profit cannot be condoned.

For each contract in which profit is negotiated as a separate element of the contract price, the aim of negotiation should be to employ the profit motive so as to impel effective contract performance by which overall costs are economically controlled.

To this end, the profit objective must be fitted to the circumstances of the particular procurement, giving due weight to each of the effort, risk, facilities investment, and special factors set forth in this 3-808. This will result in a wider range of profits which, in many cases, will be significantly higher than previous norms.

One further note, I believe, is appropriate. The imposition of more Government regulation can only work toward reducing productivity and increasing costs in an industry historically known for low profitability.

The third reason for repeal is implementation of the Vinson-Trammell Act is impractical and uneconomical. This act, passed in 1934, suspended in 1951 for 25 years when the Renegotiation Act was in force, and technically operative with the termination of the Renegotiation Act on September 30, 1976, has been rendered obsolete with the passage of time and events.

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Defense Under Secretary Perry stated in a letter to IRS that DOD has concluded that ". . . the Vinson-Trammell Act is out of date and should be repealed." Under Secretary Perry placed particular stress on the paperwork burden and costs of compliance with the Vinson-Trammell Act—"over one million—estimated—individual contract reports will have to be filed annually pursuant to the Vinson-Trammell Act by more than 30,000 contractors."

Jerome Kurtz, Commissioner of Internal Revenue, made those points clear to this subcommittee, adding that it is generally agreed the existing Vinson-Trammell is "antiquated." He also said that administration of the act by IRS could be costly, could require extensive training of IRS agents in new areas, and would result in the diversion of scarce tax administration resources to a nontax function.

There have been estimates that if IRS does have to administer the act, as it exists, it would have to hire almost 1,500 new employees at a cost of roughly $35 million. Annual costs of administration and compliance would exceed $120 million.

In considering possible alternatives, Mr. Kurtz expressed the hope that Congress "will seriously consider the costs of involving the IRS at all in the procurement area, diverting the service from its basic tax administration mission."

As you know, the IRS has granted five extensions of the due date for the initial contractor filings under the Vinson-Trammell Act, the most recent one being to April 15, 1980. I understand it has been recently extended now to Otcober 15, 1980.

It is fair to conclude that the obvious problems relating to administration and enforcement of the Vinson-Trammell Act played a significant part in the granting of these extensions.

Fourth, and last, implementation of the Vinson-Trammell Act will further erode the Nation's industrial base. The aerospace business community has experienced a sharp resurgence during the past 2 years due to the development and production of new generation commercial transports. Industrial production of aircraft and parts has grown over 40 percent since the end of 1977 as reported by the Federal Reserve Board's statistics and now stands at the same level as in 1968. This flourish of new business has brought home to major airframe manufacturers the hard, cold fact that there has been a serious erosion of the supply base of aircraft materials and supplies. Following the significant declines in aircraft production levels in the early 1970's, many suppliers reacted by redirecting their products to commercial markets and the deep recession in 1975 saw many marginal small businesses close their doors.

Recent acceleration of demand has put strong pressure on the remaining limited suppliers of aircraft parts and materials to choose, in some cases, between accepting orders for military versus commercial aircraft equipment. Since the military orders are generally for smaller quantities and require rigorous Government regulation and compliance with DAR and CAS, while commercial orders can span multiple years with no Government administrative requirements, it is not surprising that our suppliers, many of which are small and minority businesses, are becoming more and more disenchanted with military subcontracts.

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The Vinson-Trammell Act, with its requirement for filing of all contracts of $10,000 and over, would impact virtually every supplier of our military needs. Thus, implementation of the Vinson-Trammell Act at this time would further aggrevate this situation and continue to drive small suppliers away from Government subcontracts.

The act would mandate a ceiling on profits of 12 percent during a period when inflationary risks are at the highest point ever and when the effective cost of money, a nonallowable cost for Government contracts, I might add, is running well over 20 percent. These economic realities, in combination with Vinson-Trammell, would simply overwhelm the financial capabilities of small business. It seems more appropriate that the Federal Government should be concentrating its efforts towards attracting more suppliers to our industry, not less, in order to insure adequate competition at all levels of subcontracting. Increased competition provides the most effective means of meeting our national defense needs at the lowest cost to taxpayers.

In summary, unnecessary Government regulations will only reduce productivity and spur inflation in defense spending. Clearly, such regulations are not in the American taxpayer's interest. The Vinson-Trammell Act is a classic case of an outdated and unnecessary regulation whose time has come. The Cranston-Lugar bill, S. 1687, provides the best, quickest and surest solution—repeal.

I thank you, Mr. Chairman, for this opportunity to appear before this subcommittee. I would be happy to answer any questions.

Senator MORGAN. Thank you, Mr. Paladino. You have given a very comprehensive statement. As you know, the Vinson-Trammell Act covered ships and aircraft production. That obviously reflects the concern in years past that those two areas offered the greatest chances for excessive profits.

What is the present profit picture in the major aerospace companies?

Mr. PALADINO. I would say generally speaking improved but still bleak.

Senator MORGAN. Is the level of 12 percent profit on sales in Vinson-Trammell likely to be breached by your company on major defense contracts?

Mr. PALADINO. I would say this, Senator. You have to understand that a 12-percent profit in the case of aircraft manufacturers does not provide for such necessary business expenses, the biggest one obviously being the cost of interest. These costs, defined as unallowable costs in government procurement, amount to 2 to 3 percent of sales. So automatically you have a three-point reduction, so you are already now talking approximately 9 percent.

Now, in a recent survey conducted by Citibank, which encompassed 41 manufacturers during the 1977–78 time frame, they found the average manufacturing after tax profits for these 41 industries as a whole was something in excess of 5 percent. In the case of aerospace, which is a combination of military and commercial aircraft, it is something less than 5 percent.

So, you can see by these statistics that we are trailing the major industries in the country.

Senator MORGAN. In other words, unless there is substantial improvement in the picture of profits, all that the Vinson-Trammell Act

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would do would be to cause you additional burden and expenses, and would not insure any benefit for the Government.

Mr. PALADINO. That is correct, sir.

Senator MORGAN. Why is it important whether the profit limitation system applies on a contract to contract basis rather than on an aggregate business basis?

Mr. PALADINO. Obviously, on a contract by contract basis it will create significantly more burden than on an aggregate basis in total in the fiscal year.

Senator MORGAN. Well, let me pursue another line of questions and another thought.

Assuming that Congress should decide that there should be some alternative to the Vinson-Trammell and that there should be an alternative way of measuring profits which would be fair to the companies involved, is there a way that you would suggest? It is a hard question when you favor repealing it, but I am saying, if you can't have your way, what would you prefer? [General laughter.]

Mr. PALADINO. What I would prefer is to go with what is already in place. As I indicated earlier in my testimony, Senator, there is more than adequate protection, legislation, and organization in place to protect the Government. There is the give and take of negotiation even in those sole source procurements, because in many instances I think it is important to note for the record that most of these are follow-on work, and there is a point that is missed that when there is follow-on work, the Government has total access to past historical cost information, and access to records. Therefore in many instances, I know, in speaking for our own company, Grumman, they have as much information or more than we do at the time of negotiation.

Senator MORGAN. Well, I think that is what someone, Mr. Roberts or someone told me would probably be the situation in my Time magazine article on Boeing.

Mr. PALADINO. No question about it.

Senator MORGAN. We appreciate your coming, all of you who testified. As you know, Mr. Roberts is the chief counsel. He has given me a lot of questions he would like to have answered. I think, John, I have probably covered them, or they have covered them, but if in reviewing the record we find that we need more information, we would appreciate the opportunity of writing to you and asking you to furnish it to us.

Mr. PALADINO. [Nods affirmatively.]

[Questions submitted by Senator Humphrey follow:]

QUESTIONS SUBMITTED BY SENATOR GORDON J. HUMPHREY, ANSWERS SUPPLIED BY CARL A. PALADINO

Question. I have two questions that I would like to propose to you regarding a risk/benefit analysis of the various proposals on Vinson-Trammell. It is my belief that if we were to leave Vinson-Trammell in place, the bureaucracy required to implement it would outweigh the benefits in terms of excess profits returned to the government. Do any of the proposals before the Congress in your judgment have enough benefit to outweigh the costs of the bureaucracy enforcing them, and your own industry's cost of complying?

Answer. Senator Humphrey, it is my firm belief that all of the proposals before the Congress to limit profits would be wasteful and counter-productive. In my opinion, the costs of administration and enforcement would far outweigh any

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alleged excess profit recovery. As I indicated in my testimony, government protective measures against excess profits are already in place. Therefore, further laws and regulation would be an unnecessary duplication and waste of taxpayer dollars.

Question. Another argument for some limitation is that it would deter excess profits by the defense industry. In your judgment, would any benefit of deterrence value of any of these alternatives be worth the cost of enforcement and compliance?

Answer. In my judgment, the deterrence value, if any, of the various alternatives to limit profits would not be worth the cost of enforcement and compliance. Again, such alternatives are unnecessary and would be a gross waste of taxpayer dollars. They would only further contribute to the erosion of this Nation's military industrial base.

Senator MORGAN. We have a number of prepared statements by people that did not personally testify, however, they have asked that their statements be made a part of the hearing record.

[The statements follow:]

PREPARED STATEMENT BY HON. DOUG BARNARD, JR.

Senator Morgan, and members of the Subcommittee on Procurement Policy and Reprograming, I deeply appreciate the opportunity to present my approach to replacing the Vinson-Trammell Act. That antiquated legislation, which has only reappeared because of a legislative quirk, has no place in modern defense procurement, and needs to be repealed as rapidly as possible.

The current Vinson-Trammell Act is all that remains of the Vinson-Trammell Naval Parity Act of 1934. The original statute provided or the modernization and enlargement of the United States Navy to levels authorized by the Washington Treaty of 1922 and the London Treaty of 1930.

Because of the huge amount of procurements that were authorized by the act, Congress feared an impact on the marketplace equal to that during wartime. Remembering the World War I scandals about wartime profiteering, Congress attached a rider that limited all profits on contracts and subcontracts to a total of 10 percent of the final price.

In the face of a similar expansion of the Air Force, the act was amended in 1939 to add a 12 percent limitation on aircraft profits, after a 1936 amendment had excluded scientific equipment from computation of the profit.

In 1940, Vinson-Trammell disappeared after being superceded by other profit limitations, and only reappeared by accident last year. When the Renegotiation Act of 1951, the latest in a series of wartime profit limitations, expired in 1976, and the Renegotiation Board went out of existence on March 31, 1979, the provision superceding Vinson-Trammell expired, and the act re-emerged.

It is absurd to subject defense industries of 1980 to a profits limitation that was last revised 41 years ago, at a time when nuclear power was a dream in one man's head and the age of the biplane had just ended. Recognizing this, the Internal Revenue Service has performed one of the few commendable feats of bureaucratic inertia. However, unless action is taken—and soon—an onerous burden will be placed on defense contractors at a time when once again our country is trying to rebuild its obsolete defenses.

Any defense supplier with a contract to provide any parts or furnishings for a new ship or aircraft will have to file a quarterly report to the Department of Defense, and an aggregate yearly report to the IRS for each contract with a value of over $10,000. The spectrum of articles to which the act could apply ranges from floor coverings to ammunition, from fuel to furniture, and from power plants to plumbing.

Since the regulations are statutorily based, they are assumed to be included in all applicable contracts despite the presence or absence of a contract clause. Virtually any company could be subject to the Vinson-Trammell Act and its implementing regulations.

Compliance costs will be high. A producer of such simple items as radios or ammunition will be forced to keep three sets of books: one for aircraft related sales, one for ship related sales, and one for other defense contracts. In addition, the estimated 10,000 contractors who will come under this act will have to file an average of 50 reports apiece per year at a cost of 8 hours labor and $160 each to

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complete. This $80 million total filing cost will be passed on to the government in the form of higher prices, and by the time the annual 500,000 reports have been processed, the total annual cost of Vinson-Trammell may reach as high as $240 million wihout any guarantee of recovered profits to offset the cost.

What is worse, Vinson-Trammell is totally unnecessary. Times have changed for businesses since 1939, when the corporate tax rate was 13¾ percent instead of 46 percent, deflation rather than inflation was the major economic worry, and the Departments of War and the Navy had no mechanisms to audit costs of defense contracts.

Since 1939, the Truth-in-Negotiations Act (Public Law 87–653) has been passed; a powerful sanction which promotes sound and open negotiations between government and defense contractors. In addition, the Cost Accounting Standards Board, authorized by the Cost Accounting Standards Act (Public Law 91–379), has accomplished pioneering work in establishing common standards of accounting for contract costs. As a result, the government can better determine what costs it is actually paying for in a negotiated contract.

Procurement officials and contracting officers are highly trained competent individuals today. Contracting officers have the power to conduct an on-site audit at any time during the performance of a contract. Abuse of the contract process results in refunds of both costs and profits. The work of the Defense Contract Audit Agency and the Defense Contract Administration Service has been so efficient that they superceded the Renegotiation Board as the chief watchdog of excess profits long before that agency was eliminated.

Vinson-Trammell, on the other hand, deals totally with an after-the-fact situation. In fact, since costs can always be charged against profits on the contract, thus lowering the profits, it is an open invitation to inefficiency and waste.

In the face of this evidence, it is the overwhelming opinion of legislators in both Houses of Congress that Vinson-Trammell needs to be eliminated or updated. The major controversy comes in deciding what form the repeal should take. Proposals in the House alone range from a flat repeal to a repeal including placing the old Renegotiation Board on a wartime standby basis, and from reenacting the Renegotiation Act to adding another set of bureaucratic price limitations in place of Vinson-Trammell. There are valid arguments for all of these proposals, and I would like to complement my colleagues on their work.

I do, however, have serious reservations about imposing even more regulations and limitations on an already over-regulated industry. Profit limitations in any form will inhibit productivity by removing both the incentive and financial means to provide for a productive plant and equipment.

Regardless of incentive bonuses built into profit limitations, the net result will be to reduce productivity and to increase administrative costs. The place for the government to ensure it is not getting cheated in time of peace is during the initial negotiations process, and not after the contract has been completed. After the fact profit collections are justified only if the volume of noncompetitive contracts is so great that they cannot adequately monitor costs and profits. Under normal peacetime conditions, this should not occur.

To meet possible wartime needs, however, I have proposed another alternative: H.R. 6483.

Our experiences in both World War II and the Korean War have shown us that in a major war, the huge amount of defense contracts that are necessary require special measures to prevent war profiteering. Thus, the simple repeal of Vinson-Trammell may leave any future Congress with the need to institute some sort of profit limitations.

If standby controls are needed, however, changing times may well make any set mechanism to collect excess profits obsolete well before they are needed. This is the experience we are facing today in the effects of the Vinson-Trammell Act on a defense industry 46 years after it was passed, and was one of the reasons for allowing the Renegotiation Board to expire last year.

These limitations can best be seen in Vinson-Trammell, where such weapons systems as missiles, jet aircraft, radar and nuclear warheads were not imagined or covered. Can any set of standby controls that we prepare today pretend to cover whatever new advances the future brings. In addition, economic conditions have changed substantially.

In 1939, Vinson-Trammell had a floor of $10,000, below which the provisions would not apply. This level was set so that small contractors would not face the burden of compliance costs. The 1951 Renegotiation Act, recognizing domestic inflation and the higher costs of technologically advanced weapons systems, raised

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the floor to $1 million. The two bills proposed in the House which would substitute peacetime profit curbs for Vinson-Trammell have floors of $3 million and $5 million respectively.

Unfortunately, in a period of rapidly advancing technology and soaring inflation, even if it recedes from its current levels, who could accurately predict a logical floor for even five years in the future. Any specific standby controls are likely to be more of a hinderance than a help to a future emergency situation. Instead, it would seem more logical to leave in place just the bare authority for regulations dealing with excess profits, along with certain requirements the regulations must meet.

This is the approach of H.R. 6483. It requires the President in time of war to recommend to Congress regulations to control excess profits on defense contracts if he determines they are necessary.

The regulations must include a standard for determining excess profits, and set a floor for coverage of contracts so that small contractors are not unfairly burdened, and the government is not faced with huge administrative expenses. Once a standard for excess profits has been set, a specific procedure for determining them that can be objectively applied to all contracts above the threshold is required. Finally, the United States Court of Claims is given exclusive jurisdiction over claims, so that an appeals mechanism will protect against unfair actions on the part of either the government or the contractors.

Since these regulations can only be proposed in time of war, when rapid action may be necessary, an expedited approval procedure by Congress is provided for. However, Congress still has the final control, as either House may veto them within thirty days after they are proposed. Finally, to prevent another Renegotiation Board from existing long after its usefulness has ended, the regulations can only remain in force for a maximum of five years, unless they are extended by a positive vote of both Houses of Congress for a maximum period of one year at a time.

This simple structure will allow maximum flexibility for future Congresses to mold needed emergency regulations to the needs and problems of their times. At the same time, H.R. 6483 mandates that these regulations be fair and impartial, so that both the government and defense contractors will be treated without prejudice. No detailed structure to get out of date and obsolete is required, and we do not limit the future to the economic assumptions of today.

Thank you.

PREPARED STATEMENT OF MILTON D. STEWART, CHIEF COUNSEL FOR ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION

Mr. Chairman and members of this committee: I would like to take this opportunity to thank the Committee for extending me the opportunity to present my views on the defense contractor profit limitations of the Vinson-Trammell Act (V-T) and their potential impact on small business defense contractors.

As you may be aware, the Office of the Chief Counsel for Advocacy for Small Business was created by Public Law 94-305 to serve as a focal point for small business complaints regarding Federal agency policies, and to represent the views and interests of small business before the Federal Government.

SUMMARY

The Office of Advocacy has received many expressions of concern from small business about the impending implementation of V-T. As a result of our dialogue with these small business contractors and our own investigation, we believe that V-T, if implemented in its present form, would cost more to administer than would be recovered in excess profits and would result in a dangerous erosion of the defense industrial base. Foreseeable results would be:

A horrendous paperwork burden for both the Government and small business contractors;

A multiplier effect, which would result in the dollar amount of small business subcontracts subject to V-T exceeding the amount of prime contract awards subject to V-T;

An inability of small business subcontractors to determine which contracts are for part of a complete naval vessel or military aircraft and hence subject to the Act, especially on a retroactive basis;

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An inability of small business accounting systems to provide the accounting data necessary to comply with V-T, especially if V-T was applied retroactively.

The passage of nearly four years without implementation since V-T became applicable due to the expiration of the Renegotiation Act of 1951 has not been without its consequences. As a result of this passage of time:

Many small businesses have been forced to include contingent liabilities for amounts potentially due under V-T on their financial statements. This has made it extremely difficult for them to obtain needed financing;

It is almost impossible for small business to comply with V-T retroactively.

As a result of these problems, we recommend that Congress repeal V-T retroactive to its October 1, 1976 resurrection. If Congress concludes that a profit limitation is needed, small business should be excluded or, in the alternative, the dollar threshold for applicability should be set sufficiently high to achieve this result. GAO, in its statement, has recommended a dollar threshold of contracts over $10 million that would be adjusted for inflation.

BACKGROUND

The Vinson-Trammell Act, which was enacted in 1934, imposes profit limitations on contracts and subcontracts for the construction or manufacture of naval vessels and military aircraft. The applicable profit limitation is 10 percent of the total contract price for naval vessel contracts and 12 percent for military aircraft contracts. The Act exempts from its profit limitations contracts and subcontracts of $10,000 or less.

Vinson-Trammell has been in effect very few of the 46 years since its 1934 enactment. It was suspended during World War II because it was perceived as an ineffectual profit limitation that was hindering the defense effort. A 1943 law review article describes V–T's wartime repeal and its failure as a profit limitation as follows:

"The Vinson-Trammell Act, and its amendments must be written off as a failure, even in peacetime, in accomplishing any effective profits control. According to a statement of the Treasury Department, the net amount assessed under the Act on contracts for Navy vessels and aircraft up to August 31, 1942, was roughly $7,450,00, and on Army aircraft contracts for the same period, $70,000. As plans for vastly increased procurement of war munitions were made after the fall of France in 1940, it was established that the Vinson-Trammell Act limitations were making shipbuilders and aircraft manufacturers reluctant to enter into contracts and were definitely delaying the war program. Investigations of profits on the contracts of the armed forces, after suspension of the Vinson-Trammell Act, have quite conclusively established that the Act was ineffectual to prevent very large profits to certain contractors." [1]

V–T was effective for only two years after World War II. It was suspended from 1948–1951 by the Renegotiation Act of 1948 as amended and from 1951 to September 30, 1976, by the Renegotiation Act of 1951. Although technically in effect since the September 30, 1976 expiration of the Renegotiation Act of 1951, the IRS has granted six extensions of the due date for contractor filings. The present due date is October 15, 1980.

Recently the IRS and DOD have published proposed V–T regulations for comment in the Federal Register and have held hearings on the proposed implementation. The Office of Advocacy perceives severe financial and administrative hardships for small business if the Act is made effective, and I urge this Committee to provide legislative relief.

V–T would impose a horrendous paperwork burden on small business contractors and the Government

The implementation of V–T would seem to be inappropriate at a time when the Administration has by Executive Order requested all Federal agencies to make a concerted effort to reduce the paperwork burden on small business. For fiscal year 1980 alone, it is estimated that 9,900 firms [2] would have to file approximately 50 reports each with DOD and the same number to Treasury—a total of almost 1 million forms. Where adequate accountng data is available, which for the reasons later described in most likely not the case for small businesses, it would take ap-

[1] Hensel and McClung, "Profit Limitation Controls Prior to the Present War," 10 Law and Contemporary Problems 187, 204–205 (1943). (Footnotes omitted)

[2] This figure is for both large and small firms. We were unable to obtain statistics isolating small firms.

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proximately 8 hours per form of professional time to gather up the data and use it. The estimated cost of professional time is $15 per hour. Thus the aggregate cost for business to comply with V–T for one year would exceed $120 million.

It should be emphasized that this estimate is for fiscal year 1980 alone. Assuming V–T is retroactively implemented for fiscal years 1977, 1978, and 1979 as is required in the absence of a retroactive statutory repeal, contractors would incur similar compliance costs for these years. In fact, the cost of compliance per form for these earlier years is likely to be greater due to a lack of adequate accounting data. Thus the cost of compliance for these earlier years could conservatively exceed $500 million and may in fact be greater even than that.

The cost of implementation would not fall on the private sector alone. It is my fear that a new army of bureaucrats will be hired by DOD and IRS to enforce these paperwork requirements against small business. This seems particularly inappropriate given the present initiative towards less rather than more paperwork. Additionally, the implementation costs would likely exceed the amount of excess profits recovered under V–T.

Due to a multiplier effect the dollar amount of small business subcontractors subject to V–T would exceed the amount of prime contract awards subject to V–T

Due to a multiplier effect the dollar amount of small business subcontracts subject to V–T would likely exceed the dollar amount of prime contracts awarded to larger firms. The dollar amount of prime contracts subject to V–T for fiscal year 1980 alone is approximately $15 billion. For fiscal years 1977–79, which would be of concern if V–T were to be applied retroactively, the dollar amount is approximately $39 billion.[3]

DOD statistics show that 80 percent of the dollar amount DOD prime contracts subject to V–T are subcontracted and that 50 percent of this subcontracting is with small business. Although subcontracting figures are not available below the first tier, it is clear that the percentage subcontracted decreases and the percentage of subcontract awards to small business increase at lower tiers. Assuming that the percentage subcontracted is 70, 60, 50, and 40 percent for tiers two to five and that the percentage subcontracted to small business is 60, 70, 80, and 90 percent for these tiers, $20.5 billion of subcontracts would be awarded to small business for $15 billion in prime contracts subject to V–T. This is illustrated by the chart below.

ILLUSTRATION OF MULTIPLIER EFFECT ON SUBCONTRACTS FOR $15,000,000, FISCAL YEAR 1980 CONTRACTS SUBJECT TO VINSON-TRAMMELL

[Dollar amounts in billions]

			Subcontracts awarded to small business	
	Amount	Percent subcontracted	Percent	Amount
Subtier:				
1	$15.0	80	50	$6
2	12.0	70	60	5.04
3	9.6	60	70	4.03
4	8.0	50	80	3.2
5	6.4	40	90	2.3
				20.5

Many small business subcontractors would be unable to determine what contracts were for all or part of a new naval vessel or military aircraft and hence subject to V–T; traceability problems much greater if V–T is applied retroactively

V–T requires contractors to submit reports and pay any excess profits on all contracts or subcontracts for all or part of any naval vessel or military aircraft. Small businesses generally participate in naval vessel or military aircraft contracts as subcontractors. Small business subcontractors, especially those below the first tier, are often not in a position to determine whether the items they are

[3] Facts obtained from interviews with Pentagon officials, and informal review of budget line items.

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providing are to become a part of a new naval vessel or military aircraft. Often a large prime contractor or higher tier subcontractor will purchase an item for general stock. It may ultimately be incorporated in a new naval vessel or military aircraft or on the other hand be used for commercial business or sold to the Government as spare parts.

It is patently unfair for the Government to require subcontractors to trace the ultimate destination of the items they sell, especially when the buyer may be unable to tell them at the time of the transaction. If V–T is applied retroactively, as is required in the absence of legislative action, compliance may be practically impossible in many cases.

Small businesses generally lack the accounting systems necessary to comply with V–T, especially retroactively

V–T requires the computation of excess profit on a per-contract basis rather than the annualized basis on which most small firms compute their earnings. Unlike larger firms, most small businesses do not have elaborate cost accounting systems that readily compute profits on a per-job basis. In order to comply with V–T, many small businesses would have to go through the unproductive exercise of altering their accounting systems. This would be the case for a per-contract profit limitation such as V–T regardless of what accounting rules are required by regulation.

Many small firms would probably refuse Government work rather than alter their accounting systems. Since the benefits to be derived from forcing small firms to adopt more sophisticated accounting systems do not justify the administrative burden and resulting erosion of the defense industrial base, the Cost Accounting Standards Board exempted small businesses from cost accounting standards. Congres should apply a similar cost-benefit analysis to the per-contract accounting required by V–T, and retroactively exempt small business from the Act if it is not repealed.

Problems resulting from the nonimplementation of V–T since it became applicable on October 1, 1976

V–T became applicable again as a result of the September 30, 1976, expiration of the Renegotiation Act of 1951. Despite almost four years of technical applicability, it has not been implemented by DOD and IRS. We do not criticize DOD and IRS for their actions. We believe that their decisions were based on the absence of regulations necesary to apply V–T to modern day procurements and the likelihood that Congress would render the matter moot by either retroactively extending Renegotiation or repealing V–T.

The passage of time has made it more burdensome and unfair to apply V–T retroactive to October 1976. As previously noted, V–T, even when applied prospectively, confronts small business with problems relating to tracing the ultimate use of the goods they sell and cost allocation. Given the absence of detailed guidance on how to apply V–T during this hiatus and the likelihood that Congress would likely render the matter moot, many small business contractors either never complied or have disposed of the records they would need to comply with V–T. Even assuming such records are available retroactive compliance would be unduly burdensome, if not in many cases impossible. That is why we concur with GAO's statement to the Committee that a retroactive application of V–T would be both uneconomical and unfair.

The nonimplementation of V–T has also resulted in another problem. Many small businesses have been forced to report amounts potentially due under V–T as contingent liabilities on their financial statements. This has precluded many firms from obtaining necessary financing. Congress should act to remove this cloud from small business contractor financial statements.

CONCLUSION AND LEGISLATIVE RECOMMENDATIONS

For all of the reasons described above, it is not cost effective for the Government to apply V–T to small business contractors. More specifically, the cost of administration by the Government would exceed the excess profits that would be recovered. It is also clear that the application of V–T to small business contractors would lead to a significant erosion of the defense industrial base. From the course of the hearings to date, these points do not appear to be matters of contention.

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If Congress concludes that a profit limitation such as V–T is necessary, small businesses, as defined by SBA regulations for procurement purposes, should be expressly excluded. A lesser acceptable alternative would be to set the per contract dollar threshold for such a limitation at such a level that small business would be effectively excluded. GAO in its statement recommended a dollar threshold of $10 million that would be adjusted for inflation for this purpose. We would find this acceptable. If the Committee finds the $10 million alternative too high, I would suggest as the least acceptable alternative to small business that a $5 million exclusion be adopted, as proposed in S. 2331 which is identical to the Patterson bill (H.R. 5433).

If it does nothing else, Congress should act to eliminate the retroactive application of V–T, to small business. For the reasons previously noted, a retroactive application of V–T to small business would be both unfair and cost ineffective.

Thank you for providing me with the opportunity to present my views. If you have any questions, or if I can be of assistance, please let me know.

PREPARED STATEMENT OF THE MACHINERY AND ALLIED PRODUCTS INSTITUTE, CHARLES I. DERR, SENIOR VICE PRESIDENT

This statement consists of three parts:

1. A summary of the Institute's position and certain general comments regarding the Vinson-Trammell Act and various legislative proposals that have been introduced in this area.

2. A detailed critique of the Patterson bill, H.R. 5433, and the identical bill introduced for discussion by Senator Morgan, S. 2331.

3. A reproduction of our comments to the Commissioner of Internal Revenue on the proposed regulations relating to the profit limitations of the Vinson-Trammell Act updated to March 12, 1980, the date of the hearing on the proposed regulations as conducted by the Internal Revenue Service.

PART I. STATEMENT OF THE MAPI POSITION AND INTRODUCTORY COMMENTARY

It is fair to say that the opinions in government and in the private sector regarding the viability of the Vinson-Trammell Act in its present form are uniquely in agreement. The Act, which is technically in effect due to the expiration of the renegotiation statute, is obsolete, inequitable, and unadministrable. It should not be implemented in its present form. The Institute goes one step further and urges its prompt and immediate repeal. There is some but a limited body of opinion—notably the view expressed by Senator Pell and Congressmen Patterson and Minish—that the Vinson-Trammell Act should not be repealed outright but should be amended, but all agree that Vinson-Trammell should not become operative.

MAPI does not favor the enactment by the Congress of any substitute for Vinson-Trammell and/or renegotiation in the form of a retrospective recapture of so-called excessive profits. We consider such legislation unnecessary and inadvisable as a matter of public policy. If, however, the Congress in its wisdom should continue to have some concern about a relatively narrow type of contracting situation where normal procurement procedures cannot be fully utilized so as to create some possibility of windfall or otherwise excessive profits, it is our judgment that serious consideration of any such approach requires a comprehensive and very careful study which will be time consuming. Any such study, which Congress may choose to mandate, should be undertaken separately and should not interfere with immediate repeal of the Vinson-Trammell Act.

Turning briefly at this juncture to pending bills, our positions on such proposed legislation are as follows: We support the porposals to repeal the Vinson-Trammell Act outright, such as S. 1687 introduced by Senators Lugar and Cranston. We oppose strongly the proposals to substitute a new form of retrospective recapture of so-called excessive profits such as S. 2331 introduced by Senator Morgan, which is an identical bill to Congressman Patterson's earlier proposal, H.R. 5433. We oppose the essence of Senator Pell's bill, S. 2332, which is an attempt simply to raise Vinson-Trammell Act contract thresholds from $10,000 to $1 million, notably for the purpose of assisting small business. We are equally opposed to Congressman Minish's proposal (H.R. 3623) to resurrect and extend the reach of renegotiation.

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First, why should the Vinson-Trammell Act be repealed? As already indicated, the Vinson-Trammell Act is a wholly obsolete statute enacted over 45 years ago and addressing a procurement situation which is radically changed. Profit limits of 10 percent and 12 percent may have been appropriate in the 1930s. They are wholly obsolete in the inflation-ridden 1980s. The Vinson-Trammell Act is inequitable for a number of reasons, including the fact that it is limited to naval vessels and military aircraft and subcontracts thereunder. It is inequitable on other grounds which we deal with later, particularly in Part III of our statement which is a reproduction of our comments to the IRS on proposed regulations. The statute is replete with technical problems, these problems also being documented in our comments to the IRS. The law is not clear with respect to the degree to which it is applicable to subcontracts, that is to say, how many tiers are affected.

If implemented, there is the question as to whether the law is retroactively applicable to the date of the expiration of renegotiation or only prospectively applicable. The law creates all kinds of problems for prime contractors and subcontractors in terms of identification of covered subcontracts and it contains a built-in temptation for prime contractors to pass along indiscriminately a Vinson-Trammell applicability clause to subcontractors simply to protect the prime contractor. The paperwork which would be engendered by implementation of the Vinson-Trammell Act would be overwhelming as testified to in detail by Department of Defense representatives.

Should Vinson-Trammell be replaced by some other profit limitation device? In our judgment, there are at least four reasons which argue against any such action.

First, the existing complex of controls on defense contracting is sufficient, in our judgment, to prevent any excess profits in defense work except in the most unusual circumstances. By way of brief review, the more important of such controls include the Truth in Negotiations Act, profit guidelines and hard-nosed negotiation, cost accounting standards, and seemingly endless contract audits.

Second, there has never been a greater national need for profits than exists today. Profit is the incentive which calls forth the contractor's best effort. It is the attraction for investors to contribute needed capital to new and growing enterprises. It is the means by which new and better productive equipment can be obtained and productivity increased. On this point, one need only consider the shocking fact that productivity actually declined in the United States last year to see the need for the renewal of our productive plant and this can only be accomplished if business profits are adequate. It should be added that, in many defense industries which operate on the very frontier of technology—and where the products of research may at one stroke obsolete relatively new and still productive capital equipment—the need for adequate profits would seem to be even greater. For all these reasons we ought not suppress the natural forces of our economy by the dead hand of profit control.

Third, to continue institutionalized profit control under any of the methods employed in the past, such as renegotiation or Vinson-Trammell—or any of the substitutes now proposed and discussed above—would be absolutely contrary to the administration's wholly admirable drive to reduce government regulations. This drive, it should be added, is one in which the Congress itself, in its current consideration of regulatory reform, is directly engaged.

Fourth, there should be no general profit limitation statute enacted as a substitute for Vinson-Trammell because if government contracting profits are inadequate—and by almost any standard of measurement overall defense profits have been inadequate—there will be a further erosion of our defense production base—some of which has already occurred. This aspect of the question is discussed more fully below.

It is our understanding that the Subcommittee is particularly interested in the effect that implementation of the Vinson-Trammell Act or any similar statute would have on the defense contractor base. In our judgment, and this is confirmed by the opinion of the Department of Defense as expressed before this Subcommittee by Deputy Under Secretary of Defense Dale W. Church, that the burdens, cost of compliance, uncertainties, and restriction on profit that would flow from implementation of the Act would cause a very substantial departure from the procurement community by contractors, particularly smaller ones which have an option to continue a viable business without government contract work—prime or subcontract.

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It is impossible to adduce empirical evidence on this point, but anyone sophisticated and experienced in the field of government contracts will concede that such an attrition is inevitable. The contraction in the government contract base would probably take place in several forms or a combination of such forms which, as will be readily obvious, make the collection of empirical evidence almost impossible. What are those forms? First, an existing contractor or subcontractor might choose to do no government contract business. Second, he might pare down the amount of government contract business which he is willing to tolerate and accept. Third, a company might choose not to be a new entry into the government contract field.

It is the Institute's opinion, based upon experience and observation over a period of over 20 years in the government contracts field, that the defense contract base, particularly with respect to commercially oriented companies and at the subcontract level—without reference to the Vinson-Trammell Act—has already shrunk as a result of the proliferating controls of government as applied to government procurement. For many contractors which have commercial options, doing government contract work just isn't worth the candle. To add Vinson-Trammell to the already punishing array of impacts would turn off a considerable number of additional, potential, or already existing contractors and will aggravate an already serious situation.

I have heard it said by government people that government business is so attractive that even if certain companies bow out, others will take their place and in greater number. I can only say that this is an unrealistic and uninformed judgment, except for those companies which are committed as a way of life to government contract work. Through MAPI's exposure in the field of capital goods and allied products, which is the constituency of the Institute, we are very familiar with the attitudes of individual companies which have technological competence, financial resources, manufacturing skills, and personnel depth so as to make them desirable parts of the government contract base, yet choose or will choose not to be a part of the procurement system because of the control mechanism employed by government which, of course, would be worsened—as already suggested—by application of the Vinson-Trammell Act.

The proposed legislation originally introduced by Congressman Patterson of California—H.R. 5433—which is duplicated on the Senate side for purposes of discussion by Senator Morgan's bill, S. 2331, undertakes to replace the Vinson-Trammell Act by providing for a recapture by the government of profits in excess of 15 percent of the contract price on so-called "noncompetitive" negotiated defense prime contracts and subcontracts exceeding $5 million in amount. It is based on the assumption that an alternative form of profit limitation on a category of defense contracts is in the public interest. We do not agree and offer the following critique of the premises and the detailed provisions of this proposed legislation.

Beyond these general observations and Part II of this statement on the Patterson bill, we offer our comments to the IRS on its proposed implementing regulations primarily to document why the law is unacceptable and unadministrable. We have urged that the Internal Revenue Service officials who have been assigned the horrendous task of drafting implementing regulations report back to their superiors that they have been given an impossible assignment because the basic statute cannot be implemented in any useful and meaningful way for the reasons already indicated—in brief, it is bad and obsolete law.

Although we feel strongly that the Vinson-Trammell Act should be repealed outright without the enactment of a substitute form of profit limitation in its place, we recognize that it may not be realistic to expect Congress to complete action on a proposal concerning which there is admittedly substantial opposition during the limited time remaining this year prior to adjournment. At the same time, we are increasingly concerned that, failing legislative action on Vinson-Trammell this year, the Internal Revenue Service and the Defense Department may conclude that, having already granted six extensions of the due date for the initial post-renegotiation contractor Vinson-Trammell filings since 1977, they should provide no further postponements beyond the current filing date of October 15, 1980 and generally attempt at that point to enforce the Vinson-Trammell Act as it is now written. For these reasons, although we continue to recommend repeal of Vinson-Trammell, we think there is merit in Congressman McCloskey's suggestion for a five-year suspension of the Vinson-Trammell Act, to date from September 30, 1976, and urge the Armed Services Committee to promptly approve such suspension legislation.

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As we understand it, Congressman McCloskey's suggestion is that the Vinson-Trammell Act suspension, which continued during the application of the Renegotiation Act and terminated with the expiration of statutory renegotiation to post-September 30, 1976, defense sales, simply be extended for an additional five years, that is, until September 30, 1981. Such action would mean that the Vinson-Trammell Act would not apply to defense sales during this period of time, thus eliminating any question of applying Vinson-Trammell regulations and requirements to post-September 30, 1976 transactions. Thus, although the fundamental issue of final Vinson-Trammell repeal would be deferred to next year, the proposed suspension would respond to the urgent and immediate need—on which all parties agree—of precluding full application of the Vinson-Trammell Act as it is now written at the present time.

We appreciate the opportunity to appear before this subcommittee and present the views of the Machinery and Allied Products Institute.

PART II. THE PATTERSON BILL (H.R. 5433)[1]—A CRITIQUE

Assuming repeal of the Vinson-Trammell Act, the question arises as to whether an alternative form of profit limitation on government contracts in general, and enactment of the Patterson bill in particular, is in the public interest. It is to this question that this commentary is addressed.

The Patterson bill—its basic features

In broad terms, the Patterson bill would cover all defense procurement without limitation as to subject matter (except for real property), meaning that it (unlike the Vinson-Trammell Act) would extend to such key categories as missiles, tanks, personnel carriers, artillery, etc. The bill would apply to all "noncompetitive" negotiated contracts and all first-tier subcontracts under such "noncompetitive" prime contracts, which are themselves "noncompetitive" within the meaning of the bill. The term "noncompetitive" is defined by the bill to include only those contracts—

"[T]he price of which exceeds $5,000,000 and is not based on adequate price competitive, catalog or market prices of commercial items sold in substantial quantities to the general public or prices set by law or regulation; or the final price of which includes more than $5,000,000 attributable to contract changes or modifications."

Although there would be no exemptions other than to the extent inherent in its application to only "noncompetitive" prime contracts and subcontracts, there is provision for the Secretary of Defense or a designee to waive its application in the case of specific contracts or subcontracts.

The bill would provide a profit ceiling of 15 percent of the contract price, but a deduction for profits earned under performance incentive or value engineering provisions. For the purposes of computing this limitation, costs would be determined under regulations to be prescribed by the Secretary of Defense, which would presumably mean that they would be determined in accordance with the Defense Acquisition Regulation (formerly the Armed Services Procurement Regulation) and any applicable Cost Accounting Standards issued by the CAS Board. An excess profit would be determined with reference to individual noncompetitive contracts or subcontracts thereunder completed during the taxable year. Although loss offsets among such contracts and subcontracts within that taxable year would not be permitted, a four-year carryforward would be available for a net loss on the aggregate of contracts and subcontracts completed in a taxable year against any excess profit in those succeeding taxable years.

Finally, the Patterson bill would apply only to prime contracts and subcontracts entered into after 120 days following its enactment, and it would expire, unless renewed by the Congress, five years from its enactment.

The case against the Patterson bill

In our view, the case against the Patterson bill is based on three major premises:

1. There is no need for a profit limitation on defense contracts, certainly at least in a period other than one of war or national emergency.

2. Even if some type of profit limitation might arguably be justified under certain circumstances, the Patterson bill covers far more than needs to be covered.

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[1] References to the Patterson bill apply equally to its companion proposal, S. 2331.

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3. Finally, the bill includes two major substantive faults—it allows no offsets for losses among contracts in a given year, and it does not recognize in any form the problem of inadequate profits.

The need for a profit limitation on defense contracts.—The fundamental problem with the Patterson bill, it seems to us, is essentially the same basic issue raised by the Vinson-Trammell Act and the now-expired Renegotiation Act. Any type of profit limitation and recapture authority provides the government with a "crutch," in terms of a post-contract performance control, for inadequate handling of negotiations when the contract is awarded. Whatever justification could be logically claimed for supporting extension of the Renegotiation Act through the middle 1950s, some 25 years ago, has now disappeared with the controls on defense contract pricing and costs which have been established since that time. This, of course, includes not only extensive revisions and perfecting improvements in DOD's procurement regulations (the DARs), but also the enactment of the Truth in Negotiations Act, the Cost Accounting Standards statute, and the development of the role of the Defense Contract Audit Agency (DCAA).

Despite these considerations, it has been argued that some type of profit limitation is necessary to protect the public interest against sole-source situations in connection with contracts for major weapon systems. In essence, as we understand it, the argument here is that, even where there has been extensive competition among potential contractors in connection with initial source selection, with respect to the subsequent production phase or phases the company selected has now become a "sole source" and is in a position to unilaterally dictate to the government the price on the follow-on production contracts.

As to this argument, we know of no documentation as to actual instances in which such contractor dictation has occurred. However, if there have been in fact such instances, we think that the fault lies in defective contracting techniques employed in connection with the original source-selection competition phase. Specifically, we can see no reason why the government should not be able adequately to protect the public interest with regard to pricing on follow-on production contracts, by obtaining commitments concerning such pricing in connection with source selection. The protection required for the public interest in contract pricing should be established at the time of the initial contract price negotiations and not through a profit limitation on the subsequent production contracts.

The other aspect of what we understand to be the argument in favor of a profit limitation is somewhat different. It relates to the difficulty of appropriate pricing in connection with contracts that must be placed in great haste, which obviously might include letter contracts subject to later definitization and also contract arrangements concluded by telephone. We recognize, of course, that such problems may occur in connection with the need for more-rapid-than-normal placement of contracts in time of war or national emergency. It may be that some type of profit limitation could then conceivably be desirable, but it should be imposed only by affirmative designation as to necessity in the case of a particular contract by the head of a procuring agency or his designee, and this authority should be available only in time of war or national emergency as determined to exist by the President or the Congress.

The Patterson bill—an example of "overkill."—Even if it is assumed that there may be a need for some type of profit limitation in connection with sole-source contracts—a proposition with which, in the absence of its documentation, we do not agree—it seems clear that the Patterson bill is far wide of the mark in that it covers much more than arguably needs to be covered. For example, as we have indicated above, the arguments in favor of such a profit limitation are based on the problems that allegedly can arise from what amounts to price gouging by a sole-source contractor. But the Patterson bill is not limited in its coverage to sole-source contracts; it applies to all "noncompetitive" negotiated prime contracts and subcontracts exceeding $5 million in amount. The fact is that, under the definition of "noncompetitive" in the bill, the bill's profit limitations would be applicable in cases where there might be very considerable competition among a number of sources with respect to product, performance, and even price.[2] We think the Patterson bill is unsatisfactory in that it is not drafted to accomplish the fundamental objective to which it is presumably addressed. For that reason, if the bill is to be taken seriously at all, it should be rewritten at least to deal with sole source as distinguished from "noncompetitive" negotiated contract situations.

[2] Even though such price competition does not meet the rather rigid requirements for "*adequate price competition*" under the DAR.

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The offset problem—recognition of losses and inadequate profits.—The final major issue with respect to the Patterson bill is the treatment of losses and inadequate profits. Indeed, in this respect, the techniques of the bill are far inferior to those of the Vinson-Trammell Act. First, on the issue of losses, there is no offset for losses among individual contracts completed within a given year. This is because the Patterson bill defines the term "excess profit" with reference to the profit on a specific noncompetitive contract or noncompetitive subcontract thereunder completed within the taxable year. This means that the profit limitation is applied on a contract-by-contract basis in contrast to the Vinson-Trammell Act under which the applicable profit limitations, though applied separately with respect to military aircraft and naval vessels, are applied to the "total contract price for contracts [within each of the two covered categories] completed by a contractor or subcontractor within the taxable year." The significance of this distinction[3] is that under the Patterson bill, unlike the Vinson-Trammell Act, losses or "deficient" profits on some contracts cannot first be offset against profits on other contracts in making the determination as to whether there are any excess profits in a given year for which the contractor is liable. Following is a simple example involving three contracts performed by the same contractor:

Assume that the contractor has finished three separate naval shipbuilding contracts in a given taxable year, on each of which the contract price was $10,000,000 but the profits earned were $2,000,000, $1,000,000, and −$1,000,000 respectively.

Patterson bill liability.—The contractor's liability under the Patterson bill would be computed as follows:

Contract A:	
Contract price	$10,000,000
Contract profit	2,000,000
15 pct. profit ceiling	1,500,000
Contractor refund	500,000
Contract B:	
Contract price	10,000,000
Contract profit	1,000,000
15 pct. profit ceiling	1,500,000
Contractor refund	----------
Contract C:	
Contract price	10,000,000
Contract profit	−1,000,000
15 pct. profit ceiling	1,500,000
Contractor refund	----------
Total Patterson bill net liability	500,000

Vinson-Trammell Act liability.—The contractor's liability under the Vinson-Trammell Act would be as follows:

Total contract price ($10,000,000+$10,000,000+$10,000,000)	$30,000,000
Total profit ($2,000,000+$1,000,000−$1,000,000)	2,000,000
10 pct. profit ceiling (10 pct. of $30,000,000)	3,000,000
Total contractor refund	----------
Total Vinson-Trammell Act liability	----------

Thus, although the Patterson bill would apply to a much narrower band of contracts in terms of contract type than does the Vinson-Trammell Act—only noncompetitive DOD prime contracts and first-tier subcontracts exceeding $5,000,000 in amount—its application to contracts which would be covered by both the bill and the Act in many cases might be considerably harsher because of the no-offset rule resulting from the contract-by-contract provision.

Treatment of inadequate profits.—The concept of "inadequate profits" is not even mentioned in the Patterson bill. However, since the bill provides that profits in excess of 15 percent of the contract price are excessive, it would seem to imply as a corollary provision that profits below a certain figure, e.g., 5 percent for the sake of illustration, might likewise be inadequate. Indeed, the problem of making allowance for inadequate profits as well as losses in determining excessive profits, was recognized in the Renegotiation Act and, at least with respect to military

[3] It should also be noted that when in effect, renegotiation was applied on an "overall basis."

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aircraft (although not naval vessels), was similarly recognized under the Vinson-Trammell Act. However, for reasons which are not readily apparent, there is no recognition of any sort for inadequate profits under the Patterson bill. Not only are inadequate profits as well as losses barred from offset among a group of contracts in a given year, they would not be extended the four-year carryforward available for a net aggregate loss under the bill.

Consequently, it would appear that the Patterson bill, as a minimum, should be revised to provide offsets for losses in a given year, and comparable treatment for inadequate profits in terms of both offsets and a carryforward.

* * * * * * *

It should be emphasized that the Institute's basic position is that (1) the Vinson-Trammell Act should be repealed promptly and no implementation should be undertaken; and (2) no retrospective profit recapture statute is necessary or desirable whether it takes the form of the Patterson bill or some variation thereof.

PART III. REPRODUCTION OF MAPI STATEMENT REVISED TO MARCH 12 TO IRS REGARDING PROPOSED IMPLEMENTATION REGULATIONS UNDER VINSON-TRAMMELL

As already indicated, we attach the full text of our comments to IRS regarding proposed Vinson-Trammell regulations. This material should be read in the context of the answer to the question as to why the Vinson-Trammell Act is obsolete and unadministrable, not solely as a technical review of amendatory suggestions.

PART III

MACHINERY AND ALLIED PRODUCTS INSTITUTE,
Washington, D.C., December 20, 1979.

(Revised March 12, 1980)

COMMISSIONER OF INTERNAL REVENUE
Washington, D.C.

Attention: CC:LR:T (LR-71-78).

DEAR MR. COMMISSIONER:

PROPOSED REGULATIONS RELATING TO THE PROFIT LIMITATIONS OF THE VINSON-TRAMMELL ACT

These comments were originally submitted by the Machinery and Allied Products Institute in response to the notice of proposed rule making relating to the profit limitations of the Vinson-Trammell Act for naval vessels and military aircraft, which appeared in the Federal Register of October 26, 1979. They have been updated for the purpose of the IRS hearing on March 12, 1980, during which the Institute will present brief oral comments.

As you may know, the Institute represents the capital goods and allied product manufacturers of the United States. The bulk of the output of these companies is for the commercial market, but a great many of them produce highly engineered items which are indispensable to the national defense and are furnished to the military departments at both the prime contract and subcontract levels. These companies obviously are concerned with the application of the Vinson-Trammell Act to their defense business, and in the present proposed implementation of the Act by the Internal Revenue Service.

Based upon the response of these companies to the proposed regulations and upon MAPI staff analysis, we have a number of comments and recommendations concerning the specific provisions of the regulations. Before dealing with these specific provisions, however, we think it is desirable first to discuss the Vinson-Trammell Act itself as it presently relates to defense contractors. That relationship, in our view, is of basic significance to the question of whether any attempt by the IRS at implementation and enforcement of the Act through proposed regulations is appropriate at the present time.

GENERAL COMMENTS

In brief, the Institute believes that the Vinson-Trammell Act is bad legislation, is now clearly obsolete, and ought to be repealed forthwith. We have so

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urged the Congress over the years, both during the brief periods in which the Act was in effect and subsequently during the 25 years following 1951 when Vinson-Trammell was suspended because the Renegotiation Act was in effect. Congress, however, has not acted on any such recommendations for repeal. Consequently, the Vinson-Trammell Act has become at least technically operative with the termination of the Renegotiation Act with respect to post-September 30, 1976 defense contracts and the demise of the Renegotiation Board (which administered the Renegotiation Act on March 31, 1979.

At this point, the fundamental question is whether, regardless of its technical applicability, the Vinson-Trammell Act is administrable under present circumstances and ought to be enforced as a practical matter. DOD is opposed to Vinson-Trammell application as indicated in testimony on February 25, 1980 by Dale W. Church, Deputy Under Secretary of Defense for Acquisition Policy, before the Subcommittee on Procurement Policy and Reprograming of the Senate Armed Services Committee. Earlier in a letter dated Decemebr 21, 1977 to Senator Ribicoff, Chairman of the Senate Committee on Governmental Affairs, commenting on S. 1264, a bill introduced by Senator Chiles to reform Federal procurement statutes and policy, DOD recommended repeal of the Vinson-Trammell Act on the grounds that it is obsolete, discriminatory, and unnecessary.

Also, as you know, Defense Under Secretary (Research and Engineering) Perry, in a letter to you, stated DOD has concluded that ". . . the Vinson-Trammell Act is out of date and should be repealed." In that letter, as you may recall, Under Secretary Perry placed particular stress on the paperwork burden and costs of compliance with the Vinson-Trammell Act—"over 1 million individual contract reports [it has been estimated] will [have to] be filed annually pursuant to the Vinson-Trammell Act by more than 30,000 contractors." And, of course, the Service itself has granted five extensions of the due date for the initial contractor filings under the Vinson-Trammell Act, the most recent one being to April 15, 1980. We think it is fair to assume that the problems relating to administration and enforcement of the Vinson-Trammell Act played a significant part in the Service's grants of these extensions.

Finally, in your testimony on February 25 during the same Senate Subcommittee hearing in which Mr. Church of DOD appeared, IRS took the position that the Vinson-Trammell Act is antiquated. Further, the IRS statement in effect asked that the Internal Revenue Service be relieved of involvement at all in the procurement area.

We do not recite this history in criticism of DOD and the Service for their obvious reluctance to administer and enforce the Vinson-Trammell Act—quite the contrary, we commend them for it. But it is evident that all parties, both in government and in industry, who have seriously examined the problem agree that the Vinson-Trammell Act is unworkable. In view of this, it seems inconceivable to us that the Administration will permit an attempt to administer an unadministrable statute. We assume that the administration will again recommend the Act's repeal and that such a recommendation will almost certainly be followed by serious congressional consideration of the issue. For that reason, it seems to us highly inappropriate and undesirable to put interested parties and the public generally through a rule-making exercise on the Vinson-Trammell Act at this point. Accordingly, we urge that the proposed regulations be withdrawn, and that the Service and the Treasury Department join DOD in recommending that the Administration renew its efforts seeking the repeal of the Act.

COMMENTS ON SPECIFIC PROVISIONS OF THE IRS REGULATIONS AS PROPOSED

In addition to the fundamental problems with the Act itself which we believe should preclude the issuance of these proposed regulations in final form, we have a number of comments on specific provisions of the regulations. These comments follow at this point. First we deal with "contract completion" and "cost of performing a contract or subcontract" because of their importance and in view of the fact that DOD has entered objections to the IRS proposed provisions.

Contract completion (section 160.5)

As it would be revised by the DOD proposals, this provision would read as follows (with the language added by DOD indicated by *italicizing*):

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"The date of delivery of the *last* naval vessel military aircraft or portion thereof covered by the contract or subcontract shall be considered the date of completion of the contract or subcontract unless otherwise determined jointly by the Secretary of *Defense* and the Commissioner, or their duly authorized representatives. Except as otherwise provided in the preceding sentence, the correction of defects in delivered articles or the performance of warranty *or guarantee* work in respect to such articles will not operate to extend the date of completion. If a contract or subcontract is at any time canceled or terminated, it is completed at the time of the cancellation or termination, *or such later time as may, in individual cases, be determined jointly by the Secretary of Defense and the Commissioner, or their duly authorized representatives.* As to a refund in case of adjustment due to any subsequently incurred additional costs, see § 160.19."

The IRS obviously defines "contract completion" in terms of the date of delivery of the contract item in question. The DOD proposed changes to the IRS definition would improve that definition, but they assume the adequacy of the concept that the basic criterion should be the date of delivery of the contract item. However, in our view, this concept is unsatisfactory. We think that the definition should be revised to specify that a contract would be considered to be completed, within the meaning of the regulations, "either at the time of acceptance of the last article or at the time of agreement on the final price, whichever is later." This provision should apply to contract terminations and cancellations, as well as the normal instances where the contract is performed in full.

In many situations, there can be no final agreement on or determination of final prices until some time after deliveries on the contract have been completed. For example, if the contract price is affected by cost, performance, or schedule incentives or penalties, award fees, or similar criteria, it is impossible to determine the final price until all the criteria relating to pricing have been evaluated and applied to the contract. Accordingly, to require that a contract be considered completed for Vinson-Trammell Act reporting purposes prior to final determination of the price would create needless confusion and difficulty. It would result in many contractors being repeatedly required to amend most of their Vinson-Trammell reports, thereby increasing administrative burdens, including costs and paperwork, for no apparently worthwhile purpose.

Cost of performing a contract or subcontract (section 160.9)

This provision states that contractor costs shall be determined in accordance with rules and regulations of the military departments which are set forth in the Cost Accounting Standards promulgated by the CAS Board and in the contract cost principles prescribed in Section XV of the Defense Acquisition Regulation (DAR). DOD would delete this provision and substitute in its place one which would distinguish between the issue of allocability and of allowability. Under the DOD proposal, costs would be allocated in accordance with the Cost Accounting Standards and/or Section XV of the DAR if and to the extent so agreed in the contract or subcontract (in the absence of such an agreement, such allocation would be "on a reasonable basis consistently applied that reflects recognized accounting principles and practices"). Cost deductibility under Chapter 1 of the Internal Revenue Code would be the criterion for determining cost allowability for the purpose of computing the cost of contract performance.

With one exception, we endorse the DOD proposed changes. That exception relates to the last sentence of Section 160.9(a) which proposes the use of IRS Regulations Section 1.861–8(e)(2) as a basis for allocation of interest expense. That regulation is used primarily for allocation of deductions against U.S. and foreign source income in determining foreign tax credits. The regulation is extraordinarily complicated and can result in unrealistic allocations. For this reason, we recommend revision of the last sentence of proposed Section 160.9(a) to read as follows:

"Interest expense shall be allocated on a basis that reasonably and equitably apportions such expense to contracts and subcontracts."

Our support of the general thrust of the DOD proposed changes is based on the following reasons. First, it is clear that the DAR contract cost principles when combined with the application of the Cost Accounting Standards are considerably more restrictive in terms of what costs are allowable than the comparable treatment in the Internal Revenue Code rules concerning allowable cost deductions. For example, legitimate costs relating to interest, contributions, advertising, and

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depreciation, among other items, would not be allowable under the DAR rules but would be under the IRS rules. Such DAR disallowances have been estimated, by both DOD and the Logistics Management Institute, to reduce defense contract profits generally by at least two percentage points below what they might be otherwise. In essence then, adopting the DAR rules will require the contractor to pay tax on his excess profits to the extent of such unallowable costs—in effect he is being penalized twice with respect to these costs.

In addition, we think it is particularly unreasonable to apply the DAR and CAS rules in the administration of the Vinson-Trammell Act to contractors who are not otherwise subject to CAS or DAR. Specifically, the CAS and DAR rules now apply generally to negotiated defense contracts exceeding $100,000 in amount and in which commercial items are not involved. However, the Vinson-Trammell Act applies generally to all contracts and subcontracts exceeding $10,000 in amount. Thus, this provision in the proposed regulations would result in applying CAS and DAR where it would not otherwise be applied—to all formally advertised contracts over $10,000, all "competitive" negotiated contracts over $10,000, and all "noncompetitive" contracts between $10,000 and $100,000. This clearly would have the effect of tending to drive out of the defense market those contractors and subcontractors who have thus far been willing to sell in that market only on the condition that they not be subjected to the DAR cost allowability and CAS rules.

Definitions (section 160.1 of the regulations)

Complete naval vessel or military aircraft.—Subsection (b) defines this term as "a newly constructed naval vessel or military aircraft that has been furnished with all articles that are necessary for the performance of its intended service." We think that this definition should be revised to delete "all articles that are necessary . . ." and substitute in its place "items which form an integral part of any newly constructed or manufactured naval vessel or military aircraft." This would exclude consumable items which are not an integral part but are attached to the vessel or aircraft—such as missiles, rockets, torpedoes, ammunition, other ordnance, fuel, test equipment, spare parts, stores, and similar items. Indeed, we think that such an exclusion is particularly appropriate and necessary in the case of missiles, rockets, and torpedoes, when the vessel or aircraft in question is primarily a vehicle for their transmission to the point of launching.

Contract.—Subsection (c) refers to an agreement concerning the furnishing of a naval vessel or military aircraft "for the use of the Army, Navy, or Air Force." Presumably, the reference to the military departments in this context means the U.S. military departments. However, in view of the confusion that there has been in the past concerning the applicability of the Vinson-Trammell Act and/or the Renegotiation Act to Foreign Military Sales (FMS) contracts, it would be desirable to be specific on this point by including "U.S." as a modifier in the definition. This revision would simply reiterate the IRS position that the Vinson-Trammell Act does not apply to FMS contracts, which was reaffirmed in Revenue Ruling 79-230 (1979-31 IRB 8), issued on July 30, 1979.

Portion of a new complete naval vessel or military aircraft.—In subsection (k), the conjunctive requirement "and that has been furnished under a mutual understanding that is to form such a part" should be omitted. We think that this language, and its purpose, is unclear, and that including it would be likely to lead to needless controversy.

Subcontract.—As defined in subsection (1), the term would mean "an agreement entered into by one person with another person for the construction or manufacture of a new complete naval vessel or military aircraft, or portion . . . [thereof], the prime contract for which is subject to the Act." We recommend that the following sentence be added at this point: "Only the first tier of subcontracts under a prime contract is included in this term."

In our judgment, the statute is not clear on the question of whether subcontracts below the first tier are subject to the Act and its profit limitations. For that reason, we think that the Service, as a matter of statutory construction, has some discretion in the matter, and can and should exclude lower tier subcontracts. And there is no doubt that, as a practical matter, the administrative costs and burdens in flowing down Vinson-Trammell requirements below first-tier subcontracts would be enormous.

Construction and manufacture.—We urge that this term, which does not appear in the proposed regulations, be included in the Definitions and be defined

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in such a way as to exclude research, development, test and evaluation (RDT&E) efforts associated with bringing new aircraft and vessels "onto line." In normal parlance, the term "construction and manufacture" is synonymous with production or supply contracts and does not include RDT&E. Obviously, it would be desirable for the regulations to remove any ambiguity on this point by specific coverage which incorporates this general understanding as to what is meant by the term.

Scope of this part—retroactivity (section 160.2)

This provision, in effect, specifies that liability for excess profits will be imposed with respect to all subject contracts or subcontracts "completed within income-taxable years ending after September 30, 1976." In our view, this provision which makes the regulations and the application of the Vinson-Trammell Act retroactive to the termination of the Renegotiation Act on September 30, 1976—a period of well over three years—is unrealistic. It should be deleted in favor of specifying that any application of the Vinson-Trammell Act is to be prospective only. It is our understanding that contractors generally at this point simply do not have the accounting systems and recordkeeping that would provide the information necessary to comply with the Vinson-Trammell Act.

We recognize that the Service might argue, in response, that contractors are or should have been aware that the Vinson-Trammell Act became applicable with the termination of the Renegotiation Act, and that accordingly they should have taken steps at that point to facilitate their compliance with the Act. But such a response, of course, would ignore the basic point made in our general comments above with respect to any implementation of the Act itself. Although contractors may have been aware that the Vinson-Trammell Act was no longer suspended, they also knew that (1) the Defense Department had repeatedly recommended repeal of the Act, (2) this DOD position apparently had been endorsed on at least one occasion by the Administration, and (3) the Service itself had granted five extensions of the due date for initial contractor filings under the Act. Under these circumstances which indicated the government's agreement with industry that the Act is unworkable, it would have been illogical for contractors to have gone to the expense of revising their accounting systems and recordkeeping generally to comply with the Vinson-Trammell Act. In view of this, it is not only unrealistic but completely unreasonable for the Service now to insist on completely retroactive application of the Act to October 1, 1976.

Tax credits (section 160.11)

There are several problems with respect to this provision which establishes the rules relating to the allowance of a credit against the excess profit for the amount of federal income taxes paid or to be paid on the amount of such excess profit.

First, we note that the language in the proposed regulations refers to "the amount of Federal income taxes paid or *remaining* to be paid." (Emphasis added.) The word "remaining" is not in the statutory language on this point, and the reasons for including it in the regulatory language are not clear. In our view, it should be omitted. Our concern is that to include the word "remaining" in this context may imply that there is a requirement that some tax has to be paid in the years in question in order for unpaid taxes attributable to that year to be creditable. We think that any such construction is untenable under the statute, and that any possibility of such a misconstruction ought to be removed.

Second, we note that the example in Section 160.6 of determining contractor excess profit liability appears to be inconsistent with this provision because the description of the computation of the tax credit in that example does not follow the requirements of this provision. Finally, we note that there is going to be considerable confusion, and probably some technical difficulty, in computing the amount of the credit because of the fact that the regulations (unless they are changed along the lines we have recommended) require excess profit liability to be determined in accordance with the DAR–CAS rules while the income tax liability, upon which the income tax credit is to be determined, is computed under the different and more liberal rules of the Internal Revenue Code.

Failure of contractor to require agreement by subcontractor (section 160.12)

Under the Act, a prime contractor is required to put a Vinson-Trammell Act clause in those of his subcontracts which exceed $10,000 and are not otherwise exempt (as, for example, under the scientific equipment exemption). The pro-

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posed regulations provide that if a prime contractor enters into a subcontract without a Vinson-Trammell Act clause, the prime contractor will himself be liable for any subcontractor excess profits.

We think that this provision needs revision. First, it should be made clear that the requirement on the prime contractor to secure agreement from the subcontractor to comply with the Vinson-Trammell Act applies only to subcontracts that are subject to the Act. In addition—and more importantly—there should be a specific provision in the regulations permitting the military department to waive the subcontract Vinson-Trammell requirement in any case where a subcontractor whose products must be used in connection with the prime contract, refuses to accept the Vinson-Trammell requirements.

Books of account and records (section 160.14)

Subsection (b), on "Preservation of records," states that "[a] records and other evidences of costs must be retained until the contents thereof are no longer material to the administration of the Act." This, we think, is much too broad a requirement to be acceptable in this context. Specifically, the provision is completely open-ended; it would require contractors who are subject to the Vinson-Trammell Act—and it will be recalled that Under Secretary Perry mentioned over 1 million individual contract reports to be filed annually by over 30,000 contractors—to maintain complete records on all such transactions without any limitations.

It seems to us that an appropriate way to limit such a provision would be to require indefinite maintenance of records, beyond a specified term of years, only with respect to such contracts as have been designated by the IRS or DOD as contracts currently under review or audit. If no such designation is made by the government—and we assume that the IRS and DOD would not engage in "over designation" in this respect—we think that a contractor should be permitted to dispose of contract records after the specified term of years has expired.

Report to the military department (section 160.15)

This provision refers to reports, upon completion of a contract or subcontract, by "the contracting party" to the Secretary of the military department. This provision may be construed to preclude the filing of consolidated reports by related contractors. Any such construction, we think, would be undesirable because contractors are permitted to file consolidated tax returns, and this provision would needlessly complicate the determination of the tax credit against excess profits reported in "unconsolidated" Vinson-Trammell filings. Accordingly, we urge that the regulations be revised to make it clear that consolidated Vinson-Trammell Act returns are to be permitted.

COMMENTS ON THE PROPOSED DOD "REPORT OF PROFIT" FORM

In conclusion, for the information of IRS we repeat here our comments made to DOD on its proposed "Report of Profit" form.

Item 4, which is to be completed by a subcontractor, is headed "Name and Address of Firm Issuing This Contract (Include Zip Code)." From the point of view of clarity, it probably would be desirable to modify this title along the following lines: "Name and Address of Firm (Include Zip Code) From Whom This Subcontract or Order Was Received."

Item 6a reads as follows:

"This Contract or Subcontract is for construction or manufacture of all of part of ("X" one):

☐ Naval Vessel ☐ Aircraft"

Obviously the second "of" should be "or." More importantly, it would be better to follow the wording of the statute by specifying the two basic categories as "New Complete Naval Vessel" and "New Complete Military Aircraft."

The subcontractor problem

A much more serious problem concerning the form arises in connection with requirements as to subcontractor reporting under the Vinson-Trammell Act. As indicated in our comments on the IRS regulations, we recommend that subcontractor liability under the Vinson-Trammell regulations be limited to those in the first tier, and it is our opinion that the IRS and DOD have the necessary discretion to make this determination. If, contrary to our recommendation, there is to be no such first-tier subcontract limitation, that decision will result in a very

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serious problem as to determining which vendors are or are not covered as subcontractors under the Vinson-Trammell Act.

Because of the way in which the Act is framed, a prime contractor presumably is responsible for a subcontractor's Vinson-Trammell liability in the event that the prime contractor fails to obligate the subcontractor under a suitable Vinson-Trammell clause in the purchase order. For that reason, prime contractors and upper-tier subcontractors surely will be inclined to pass down Vinson-Trammell clauses and liability to their vendors even in cases where that vendor's Vinson-Trammell liability would be questionable, because of doubt as to that vendor's status as a subcontractor within the meaning of the statute.

Accordingly, it would be undesirable for DOD to issue any form for Vinson-Trammell reporting by contractors and subcontractors without first providing in the instructions detailed guidance as to what constitutes subcontract status under the Vinson-Trammell Act and how that determination is to be made.

* * * * * * *

Although we have offered recommendations for revision and improvement in the proposed regulations under the Vinson-Trammell Act, our basic position is that the Act should be repealed and no action should be taken to implement its provisions in the interim period.

We are pleased to have had this opportunity to comment. If MAPI can be of assistance with respect to these comments and recommendations, please let us know.

PREPARED STATEMENT OF KARL G. HARR, JR., PRESIDENT, AEROSPACE INDUSTRIES ASSOCIATION OF AMERICA, INC.

Mr. Chairman and members of the subcommittee: I am Karl G. Harr, Jr., president of the Aerospace Industries Association of America, Inc., the national trade association representing the nation's major manufacturers of aircraft, spacecraft, missiles, related components and equipment. As primary suppliers of advanced defense and space systems, the aerospace industry appreciates the opportunity to be here today to air our views on implementation of the Vinson-Trammell Act and related proposals.

Many witnesses have preceded me in these comprehensive and urgently needed hearings. They have included members of Congress, and officials of the Department of Defense, and General Accounting Office. There has been one common thread of agreement among all of these individuals and that is that the Vinson-Trammell Act, which became the law of the land as of October 1, 1976, with the demise of the Renegotiation Board, is totally outdated and unworkable in the present complex procurement environment. I would like to add AIA's firm endorsement of that belief.

In fact, there is no greater testimony to the complexities—and perhaps impossibility—of implementing the Act than the current difficulty DOD and IRS are having in developing final regulations and reporting forms for Vinson-Trammell. The basic, but by no means only, problems include how to define Cost, Price, Profit, Accounting Methodology, Contract Completion and, perhaps most basic of all, to specify those contracts to which the Act would apply.

Such problems are further complicated by the Department of Defense's desire to provide certain incentives which would increase the effieciency and lower the production cost of the acquisition process. The Vinson-Trammell Act might, in many cases, negate these valuable contract provisions and remove the motivation to reduce the cost of contract performance. Obviously that would be a step backward.

In addition, Vinson-Trammell itself would be costly to implement. In its request to the Office of Management and Budget for approval of its proposed Vinson-Trammell reporting form, the Department of Defense estimated that the cost to contractors of executing the paperwork would be $80 million a year. Add to that the estimated in-house cost to the government, including an additional 1,500 IRS employees to administer the Act, and the total yearly expense from all sources could be as much as $120 million. If Vinson-Trammell were to be instituted now, four years of reports would be due at the outset. Naturally, the burden on small business, including a significant number of our subcontractors, is especially onerous in this respect.

Such costs also contrast sharply with the current spirit of economy—I might even say austerity—which seems to pervade the government. In addition, im-

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plementation of such a complex and lengthy reporting system would represent a significant departure from the Administration's (and the Congress's) announced policy of reducing and simplifying government paperwork.

For these reasons, we feel strongly that neither Vinson-Trammell nor any other form of so-called profit-limiting legislation is needed. I will come back to that point, but first I would like to comment briefly on various legislative proposals which have been advanced.

As stated in his testimony to your subcommittee, Congressman Joseph Minish's bill, H.R. 3623, would amend the Vinson-Trammell Act to provide for aggregation of contracts over $3 million. Profits over 10 percent would not be allowed except where warranted under the subjective criteria of the discredited Renegotiation Act. This would amount to a return to renegotiation, with administration lodged in the Treasury Department. Congress has already determined that renegotiation is an unnecessary and counterproductive system and no one has advanced any new information to the contrary. As for turning such matters over to the Treasury Department, IRS Commissioner Jerome Kurtz has already testified that the IRS has neither the expertise nor the desire to perform such a function.

A second proposal, by Senator Claiborne Pell, numbered S. 2232, would put a threshold of $1 million on Vinson-Trammell. That proposal does not even address all other recognized problems introduced by that Act, and thus is incomplete as a possible course of action.

The proposal introduced by you as S. 2331 and by Congressman Jerry Patterson as H.R. 5433, with all due respect, Mr. Chairman, would be inequitable and costly to implement. It would determine profits on a contract-by-contract basis, an approach which has been tried and discarded in connection with both renegotiation and Vinson-Trammell. In addition, we are unclear as to some of the important definitions in the bill, such as, for example, what is meant by contract completion. In short, while this measure seems to be a genuine and thoughtful attempt to deal with what has been perceived—but never proved—to be a problem, we feel it too has definite limitations.

Two other bills, H.R. 3112, by Congressman Paul McCloskey, which would revive the Renegotiation Act in time of national emergency, and H.R. 6483, by Congressman Doug Barnard, which would require statutory profit limitation only in time of war, represent another approach which has been advanced. We in the aerospace industry, of course, have never opposed specific profit-limiting legislation during the exigencies of war time or declared national emergency. However, we would have to have more detail about how such limitations would be activated and enforced before we could commit ourselves on such legislation. In any case, we are not at war now and the first order of business is to repeal the outmoded Vinson-Trammell Act.

Further, in our opinion, there is no need for profit-limiting legislation in the orderly procurement environment of peacetime. We in AIA, and others, have been in contact with various Defense Department officials to try to get a better understanding of the nature of the problem that they, and you, are trying to solve. I must confess we are at a loss to understand what it is that must be corrected. Accordingly, we are pleased that you requested exactly that information from the DOD during the hearing on February 25, 1980, and we look forward to examining their perception of the problem.

Quite simply, our review of the last 15 years of procurement history does not demonstrate any pattern of excessive profits being realized as a result of the lack of adequate price competition. History, in fact, shows that the reverse is true. Over the years, DOD has conducted several studies, the most recent being "Profit 76," which concluded that the profit level for defense work was generally below that earned in comparable commercial areas.

The reason that the current experience with DOD procurements does not show any need for profit-limitation legislation is because of the significant improvements which have been wrought in the procurement process since World War II. Here's a partial list:

Full government access to cost data on all negotiated contracts, on which the contractor has certified that the costs are current, accurate and complete (Public Law 87-653—Truth in Negotiation and Defective Pricing Act).

Seventeen Cost Accounting Standards issued to date which require a defense contractor to estimate and record his costs in a set manner.

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Performance of both preaward and postaward audits of contractor records on all significant negotiated contracts by the Defense Contract Audit Agency, an independent arm of the procurement function in DOD.

Significant strengthening of the DOD Procurement Policy over the years to correct any perceived weaknesses. The increased experience and skill level of the people in the procurement buying activities has substantially upgraded their professional competence to protect the government's interest in negotiating and administering DOD contracts.

Better methods of customizing the contract to the situation.

Location of government representatives of the PCO and audit in most large contractor facilities to insure complete day-to-day knowledge of a contractor's actions.

Support of all payments to a contractor by a DCAA-approved voucher, thus insuring only contractually authorized payments are made.

The presence of all such safeguards and controls, coupled with the hard evidence that defense profits are indeed modest, leads us to conclude that the Vinson-Trammell Act should be repealed immediately and that nothing need be enacted in its place. Accordingly, we strongly recommend that either H.R. 3254, by Congressman McCloskey, or S. 1687, by Senators Alan Cranston and Richard Lugar, both of which would repeal Vinson-Trammell retroactively, without substitution of additional unnecessary and expensive regulations, be enacted as expeditiously as possible.

Thank you, Mr. Chairman.

PREPARED STATEMENT BY HON. DAVID PACKARD, CHAIRMAN, HEWLETT-PACKARD CO.

Mr. Chairman and Members of the Subcommittee: I appreciate the opportunity to comment to your committee in support of S. 1687 to repeal the Vinson-Trammell Act of 1934.

I will not comment on the Act itself as I understand others have or will comment at length on the unworkability of the Act dating almost from its passage nearly 45 years ago. Clearly, the Act should be repealed. I would like to comment, however, on the issue of whether there should be any new profit limitation legislation.

I have had a very long experience with the matter of profit limitation as required by the Renegotiation Act, which for many years superseded the Vinson-Trammell Act and was successfully repealed by the Congress last year. The Renegotiation Act served a useful purpose in wartime when time was of the essence, but it developed a self-perpetuating bureaucracy that served no useful purpose in peacetime as clearly came out in the hearings last year.

There may be emergencies from time to time that would call for awarding a contract without adequate cost evaluation, but I believe this kind of a situation could be adequately dealt with on a contract-by-contract basis. I believe it would be far better for the contracting people to include whatever cost or profit control requirements as may be indicated on a case-by-case basis than to enact new renegotiation legislation of any kind. There is simply no substitute for negotiating the right contract in the first place.

In my experience while Deputy Secretary of Defense, I observed that the price of a contract was of far greater importance than profit in measuring whether the taxpayers got a fair deal. To the extent that a higher percentage profit may mean a lower price, we will all benefit by stressing contract price rather than profit margin.

There is a great need today to improve the productivity and efficiency of contractors and provide incentives to achieve the best possible end result from both the government's and the contractor's standpoint. Recognizing that a large percentage of dollars of negotiated contracts are sole-source, contracting officers must insist on maximum disclosure and agreed-upon standards for allocating costs at the time contracts are negotiated. Contracting officers should not be allowed to have the comfort of assuming their sole-source contracts can be renegotiated after the fact based on an arbitrary profit limitation.

Contracting officers should be made to feel the full weight of their responsibility the first time around just as the contractor must also abide by his commitment, be it fixed fee or fixed price. The prime goal should be price for a good performance with prospective profits the incentive for greater competition.

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Our failure in the past to recognize this simple fact has resulted in a loss of Defense contractors. We should not renew this misdirected effort but instead should repeal Vinson-Trammell. No substitute for Vinson-Trammell is desirable or needed. The only appropriate application of a profit limitation is where production must commence immediately because of a recognized emergency.

In this case, a recognized emergency, where normal procurement procedures must be shortened or bypassed, a profit limit could be included as part of the contract at the discretion of the head of procurement. For example, the contract could include a profit limitation not to exceed the maximum of the contractor's highest annual profit level achieved during the past five years or 15 percent, whichever is greater, for the contractors segment or segments which performed the contract. Such a provision is not intended to guarantee a profit but sets a maximum limit which is judged to be reasonable in relation to the contractor's normal business experience. Accounting methods used to determine profitability should be those used by the contractor in accordance with the established accounting rules of the IRS.

DOD may devise other methods to achieve the same end. I am only suggesting an approach which I believe would adequately safeguard the public interest while meeting an emergency.

If the price of a contract can be reduced below the Defense Department's estimate, this should be the primary objective even if the contractor makes an above-average profit. In this way we can attract more contractors to compete, to take risks and to meet the Defense Department's needs.

In summary I disagree with those who believe there should be a regular peacetime profit limitation for all sole-source contracts or any other contracts. Such a limitation is not necessary where normal procurement procedures are followed and, in fact, would be counter-productive to the effectiveness of good procurement practice.

CHAMBER OF COMMERCE OF THE UNITED STATES,
Washington, D.C., April 14, 1980.

Hon. ROBERT B. MORGAN,
Chairman, Subcommittee on Procurement Policy and Reprograming, Committee on Armed Services, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: On behalf of the more than 96,000 members of the Chamber of Commerce of the United States, I wish to express our support of S. 1687 which would repeal the Vinson-Trammell Naval Parity Act of 1934.

The U.S. Chamber is the largest federation of business people and business organizations in this country, representing more than 92,000 business firms, 2,700 chambers of commerce and 1,300 trade and professional associations. Of our business members, approximately 80 percent are small.

In view of these figures, it is fair to say that the U.S. Chamber represents the interests of American business, large and small. Accordingly, we clearly have a vital stake in seeking to alleviate the excessive burdens of doing business with the federal government via the procurement process. Therefore, we support the repeal of the Vinson-Trammell Act.

For those of us who enjoyed witnessing the "sunset" of the Renegotiation Board in 1979, its "sunrise" in the form of a revitalized Vinson-Trammell Act and a new set of accompanying IRS regulations will likely be another dismaying regulatory story, spelling trouble for federal contractors.

The Renegotiation Act was promulgated during World War II as a device for ensuring that excessive or unwarranted profits were not realized on contracts which, because of wartime conditions, could not be priced as carefully as under normal conditions, using established procurement safeguards. "Renegotiation" was never intended to substtiute, in time of peace, for normal government practices.

After a brief hiatus following World War II, renegotiation was reimposed in March 1951, during the Korean War. However, since 1951, Congress and the Executive Branch have strengthened the federal procurement process with extensive procedural checks and balances to avoid excess profits in procurement. Literally dozens of safeguards have come into being, including The Truth in Negotiation Law (Public Law 87-653), which amended the Armed Services Procurement Act; improved work of the Defense Contract Audit Agency; the Cost Accounting Standards Board (Public Law 91-379), with many new standards

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instituted; the Defense Contract Administration Services; the Office of Federal Procurement Policy, and various cost control changes in the Armed Services Procurement Regulations.

SUNSET

In fact, both the Renegotiation Act and the Renegotiation Board, empowered to administer the Act, were "sunset" as of March 31, 1979. All the Board's functions and powers were terminated as of that date, a possible first in the recent history of governmental affairs.

With the expiration of the Renegotiation Act and the Board, the Vinson-Trammell Act of 1934 became operative. While the Renegotiation Act provided for recovery of excess profits if any, earned on aggregate business with government agencies subject to that Act, the Vinson-Trammell approach is a little different. It serves to limit the profits that holders of defense contracts related to aircraft and naval vessels can earn on their projects. The Internal Revenue Service (IRS) is authorized to carry out Vinson-Trammell.

BACKGROUND

The profit limitation provisions are all that remain of the Vinson-Trammell Naval Parity Act of 1934. The original statute provided for the modernization and enlargement of the United States Navy to levels authorized by the Washington Treaty of 1922 and the London Treaty of 1930. It was anticipated that the magnitude of the procurements authorized by the Act would have the same impact on the marketplace as that experienced during wartime.

Aware of several cases of profiteering during World War I, Congress felt the need to control the profits allowed on procurements authorized by the Act. It, therefore, amended the Naval Parity Act to limit profits on any contract or subcontract for the construction or manufacture of naval vessels and/or aircraft to 10 percent of contract price.

In a 1939 amendment to the Act, the scope of the profit limitation provisions was expanded to include the procurement of aircraft for the Army. As revised, the profit limits on contracts for naval vessels and military aircraft became 10 percent and 12 percent respectively.

From 1940 through 1976, the Act was suspended by the Renegotiation Act limiting profit on government contracts. When the authorization for the Renegotiation Act expired on September 30, 1976, the profit limitation provisions of Vinson-Trammell, unchanged since 1939 again came into full force and effect.

"SUNRISE"

Since the termination of the Renegotiation Board, the IRS and Department of Defense (DOD) have been developing revised forms and regulations for the renewed implementation of the Vinson-Trammell Act. DOD submitted a "Report of Profit" form for approval by the Office of Management and Budget in August 1978. IRS published its proposed regulations on October 26, 1979.

The paperwork burden of the Act and implementing regulations is likely to be considerable. In fact, a former general counsel of the Renegotiation Board views the Vinson-Trammell Act as more onerous and complex for contractors than the Renegotiation Act, and anticipates that accounting for materials under the long-unused Vinson-Trammell Act will be very difficult.

Contractors will be required to file reports with the DOD for each contract subject to the Act. Further annual reports aggregating the information sent to DOD will have to be filed with IRS.

FROM FUEL TO FURNITURE

The regulations apply to defense contracts and subcontracts over $10,000 for equipment or supplies to be included in a complete new ship or aircraft. The spectrum of articles to which the Act could apply ranges from ammunition to floor coverings, from fuel to furniture, and from power plants to plumbing.

Since the regulations are statutorily-based, they are assumed to be included in all applicable contracts. Virtually any company could be subject to the Vinson-Trammell Act and its implementing regulations.

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COST OF REGULATION

The cost to industry of complying with the regulations is in direct proportion to the paperwork. In the application for approval of its "Report of Profit" form, DOD estimated roughly 500,000 annual filings from 10,000 separate contractors, at a cost to contractors of $80,000,000 annually.

This estimate is a conservative one; DOD admits it could be off by as much as a factor of three! Furthermore, it does not include the contractors' cost of filing reports with IRS, the cost of audit or the cost to the government of maintaining this information.

CONCLUSION

In summary, the Act's profit limitations serve to the disadvantage of everyone—the federal government, taxpayer, and contractor.

The statutorily-imposed profit limitations discourage a contractor from reducing his costs below the point at which profits exceed the "profit maximum." This results in a government loss of tax revenue that otherwise would be realized from increased profits.

At the same time, the statutorily-imposed profit limitations discourage a contractor from reducing his costs below the point at which his profits reach the "profit maximum." This motivation to increase profits to the statutory maximum results in the government ultimately paying more for its required goods and services than is necessary.

Moreover, low cost, efficient, and profitable suppliers will not compete for government business. This reduction in competition will further compound the problem of higher costs paid by the government. All of these by-products of Vinson-Trammell are contrary to the best interests of the federal government, taxpayer, and contractor.

Evidently, some members of Congress see it the same way and steps have been taken in both the Senate and House to repeal the Act, steps the Chamber clearly supports. Senators Cranston (D-Calif.) and Lugar (R-Ind.) have introduced S. 1687, while Rep. McCloskey (R-Calif.) has introduced H.R. 3254.

I will appreciate your consideration of our views and I request that this letter be included in the hearings record.

Cordially,

HILTON DAVIS,
Vice President,
Legislative Action.

ALLIANCE OF METALWORKING INDUSTRIES,
Washington, D.C., April 24, 1980.

Senator ROBERT B. MORGAN,
Chairman, Subcommittee on Procurement Policy and Reprogramming, Russell Senate Office Building, Washington, D.C.

DEAR SENATOR MORGAN: This letter is written on behalf of the six associations that constitute the Alliance of Metalworking Industries ("AMI"). Our six member associations in turn represent 4,883 separate businesses, 98 percent of which are small businesses. It is our understanding that the hearings regarding the Vinson-Trammell Act which were to be held by the Senate Subcommittee on Procurement Policy and Reprogramming have been postponed indefinitely. AMI had prepared testimony to be presented at those hearings, and we have enclosed with this letter a copy of that testimony, AMI's testimony before the Internal Revenue Service, and letters written by AMI to the Department of Defense and the IRS. We respectfully request that all these documents be included in your subcommittee's record.

AMI firmly believes that Vinson-Trammell is an archaic, impractical statute and that it would be impossible for lower tier subcontractors, including many of the companies comprising our member associations, to comply with the Act and the proposed regulations. We believe that AMI's testimony demonstrates the following problems which would arise if the Vinson-Trammell Act is implemented in the manner proposed by the IRS and DOD.

Contractors and subcontractors would be required to maintain reserves for an uncertain financial liability under Vinson-Trammell back to October 1, 1976, thereby typing up assets needed for operations and impeding the ability to raise capital.

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There would be a paperwork blitz imposing tremendous burdens on government and industry with no identifiable return for the effort expended. It would be impossible for subcontractors to identify and trace parts subject to the Act, particularly on a retroactive basis.

Small businesses which rely on government contracting would be discouraged from undertaking desirable risks because of the Act's fixed profit levels.

Most small subcontractors would have to create a cost accounting system to be applied to many hundreds of thousands of subcontracts from as far back as 1976.

Because of these problems with respect to Vinson-Trammell and the problems identified in other testimony presented to your subcommittee, AMI believes that the IRS and DOD should no be allowed to promulgate regulations until Congress has expressed its position regarding Vinson-Trammell. To that end, we support the Lugar-Cranston bill and would support the Patterson bill and the Pell bill as acceptable alternatives to the Vinson-Trammell Act, if they were properly amended.

We understand that it may be legislatively impractical to attempt to repeal or substantively amend the Vinson-Trammell Act during this term of Congress. Furthermore, we understand that the IRS may soon issue final Vinson-Trammell regulations that would create a tremendous burden for small businesses. Accordingly, we strongly urge that, as soon as possible, the reporting requirements under the Act be suspended until late 1981 in order that the Senate might consider repeal or amendment of the Act prior to finalization of regulations by the IRS.

Respectfully submitted,

ALLIANCE OF METALWORKING INDUSTRIES,
By FRANCIS H. BACKMAN,
President, Forging Industry Association.
By LANCE MILLER,
President, Metal Treating Institute.
By RAYMOND L. BELDING,
President, National Screw Machine Products Association.
By JERRY WEAVER,
President, National Tooling and Machining Association.
By JOHN R. POPOVICH,
President, American Metal Stamping Association.
By GEORGE C. UNDERWOOD, II,
President, Spring Manufacturers Institute.

Enclosures.

STATEMENT OF THE ALLIANCE OF METALWORKING INDUSTRIES BEFORE THE SENATE SUBCOMMITTEE ON PROCUREMENT POLICY AND REPROGRAMMING

Mr. Chairman and Members of the Committee, my name is Carl W. Goldbeck, President of Otto Konigslow Manufacturing Company of Cleveland, Ohio, and I am presenting my statement as a member of the Alliance of Metalworking Industries ("AMI"). Accompanying me in presenting our views to the subcommittee are Mr. Charles H. Smith, Jr., Chairman and Chief Executive Officer of Sifco Industries, Inc., of Cleveland, Ohio, Mr. William P. Gentz, President of Gentz Industries, Inc., of Warren, Michigan, and Mr. David M. F. Lambert, Esquire, Special Counsel to AMI.

The Alliance of Metalworking Industries represents a significant and critical segment of our national manufacturing industry. It consists of six member associations: the Forging Industry Association, the Metal Treating Institute, the National Screw Machine Products Association, the National Tooling and Machining Association, the American Metal Stamping Association, and the Spring Manufacturers Institute. These six associations in turn represent 4,883 separate businesses, 98 percent of which are small businesses. These companies employ 880,250 employees and produce combined annual sales of 34.8 billion dollars. Despite these large combined sales, members of the six associations are small businesses with an average of 46 employees per plant, producing average sales of 1.82 million dollars per plant.

Despite the fact that many of our members are small businessmen, often in the lower tiers of the manufacturing process, they are essential not only to nonmilitary manufacturing, but are also essential to the defense industry. Titanium forgings for aircraft landing gear struts, critical engine parts which are machined or stamped, and nose cones which are spun are only a few of the many examples of the products produced by our member companies. Prime contractors do not

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have the expertise nor is it economically feasible for them to buy the expensive and specialized machinery required to do this work.

We are deeply concerned about the tremendous burden that the Vinson-Trammell Act and the proposed IRS and DOD regulations would impose upon the small suppliers and lower tier Manufacturing subcontractors that constitute our member associations and produce parts for aircraft and ships that may be subject to the act. For your benefit, we have attached to the written copy of our testimony a copy of our testimony before the IRS on March 12, 1980, relating to the problems that would result if the proposed IRS regulations become final. We request that this testimony be included in the record of this hearing, as well as the letters which we sent to the IRS on February 26, 1980, and DOD on March 25, 1980, commenting on their proposed regulations to implement the Vinson-Trammell Act. We believe that the positions stated in those letters demonstrate the administrative unworkability and the inherent lack of economic justification for the Vinson-Trammell Act as it applies to lower tier subcontractors.

Mr. Chairman, you and the members of this subcommittee have for the first time in over three years provided us with the opportunity to address the problems we have had, and are now facing, with the prospect of final IRS and DOD regulations concerning the Vinson-Trammell Act of 1934. We respectfully call to your attention and the attention of Congress the serious dilemma caused by the inaction of the legislative and executive branches of our country with respect to this problem.

In 1976, when Congress decided not to extend the reporting requirements of the Renegotiation Act of 1951, it did so knowing that the lapse of the Renegotiation Act reporting requirements would trigger the onerous reporting requirements of the Vinson-Trammell Act. At that time Congress should have repealed the Vinson-Trammell Act. In that session and each succeeding session of Congress, legislation has been introduced to repeal or modify the Vinson-Trammell Act. Now, over three years later, a congressional committee is actively considering the question of repeal for the first time.

In that three-year period, Treasury and DOD, two of the senior agencies of the executive branch charged with developing and issuing regulations to implement the act, did not provide any guidance for our member companies to enable them to comply with the act. IRS, acting on behalf of Treasury, issued proposed regulations for the first time in October 1979. However, it is impossible for the small lower tier subcontractors that comprise most of our member industries to comply with the proposed regulations. The General Accounting Office, in its statement to this subcommittee on April 2, 1980, expressly recognized the problems faced by small business. Furthermore, we were pleased to note that the General Accounting Office supported the position we have taken with IRS and DOD, and now take with this subcommittee, when it stated, "the Vinson-Trammell Act is not workable." We hope our testimony today and the discussion in the IRS testimony and the letters which we are submitting to you today will further clarify the extent of the burden on small business that will result if the implementation of the Vinson-Trammell Act is allowed to proceed.

RESERVES REQUIRED

Congress should be fully aware of a particularly harsh result of the failure of Congress, Treasury, and DOD to resolve the fundamental problems inherent in the act that now face our supplier industries. The result of this inaction is that the companies in our industries face uncertain and undefinable financial liabilities due to the retroactive application of the profit limitations of the Vinson-Trammell Act. As you know, most of our members are small, independently owned companies that can ill afford to show contingent financial liabilities on their financial statements. Moreover, our members will be required to set aside reserves in 1980 for potential, yet undefined, Vinson-Trammell liability for more than three years of booked profits, a liability which cannot specifically be determined under the act or the regulations and which will place an unwarranted and unjustifiable burden on our members at a time when they are already troubled by the highest inflation and interest rates in recent history.

PROBLEMS INHERENT IN THE VINSON-TRAMMELL ACT

There are problems inherent in the language of the Vinson-Trammell Act and there are additional problems in the rules which are proposed to implement the

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act. Only congressional action can remedy the problems which are inherent in the act.

We believe that the Congress which enacted the initial legislation in 1934 never intended as broad a scope of coverage as is proposed in 1980. Under the Vinson-Trammell Act, all contracts and subcontracts for the manufacture of all or part of a complete naval vessel or military aircraft would be subject to reporting and profit limitation requirements, unless the amount involved is $10,000 or less. The $10,000 minimum contract for reporting purposes was established when the Vinson-Trammell Act was first proposed by Congress and enacted into law in the 1930's. However, since that time, inflation and the increase in sophistication in military hardware have caused the number of subcontracts and the associated paperwork involved to be more than fifty times the number originally contemplated by Congress. We anticipate that the companies who are members of our member associations would have to file an estimated 500,000 reports for individual contracts each year at an estimated cost of at least $200–$250 per report. The present backlog of reports due in October 1980 could be in excess of two million. These reports would have to be based on detailed records created especially for that purpose.

An additional problem inherent in the Vinson-Trammell Act that may be remedied only by congressional action is that profits earned on the contracts and subcontracts for all or portions of naval vessels and military aircraft discriminate against those companies making those products by restricting profits to ten and twelve percent, respectively. When the 46-percent corporate tax rate is considered (a tax rate far in excess of the corporate income tax when the Vinson-Trammell Act was passed in the 1930's) an alarmingly small portion of sales remains to be reinvested or distributed to shareholders who have under taken the risk of investment. The profit limitations do not properly recognize the risks that small lower tier subcontractors have taken. These companies traditionally have invested considerable time and money in making many innovations necessary to remain competitive and in so doing have undertaken the risks inherent in operating small businesses. We believe the Vinson-Trammell profit limitations would retard our members' efficiency, survival, and growth in several ways. First, the profits allowed by the act do not provide the necessary general incentive for small businesses to undertake the risks of operation nor do they provide a proper incentive to perform efficiently. Second, the specific profit incentives generally recognized in the body of Government procurement law as needed to encourage efficiency, the assumption of risks, innovation, and various other goals are lacking in the system of fixed profit limits established by the Vinson-Trammell Act. Profits limits are basically unnecessary in our industries. With nearly 20,000 competing companies, there is close to perfect competition in our industries.

Furthermore, it is impossible to identify and trace parts which may be subject to the act. For instance, many of our members produce thousands of small parts for aircraft engines. Even when it is known that the part will go into an engine, it is not known whether that engine will become part of a military aircraft, a commercial aircraft, or a spart part for either. It is impossible to make the required determination of the destination of the part in order to make the reports required by the act and proposed regulations. It is an even greater burden to request our members to make this determination on a retroactive basis for all subcontracts completed subsequent to October 1, 1976, a determination that would require a review of records from before October 1, 1976. Moreover, in many cases, all or part of the profits that would be required to be paid back to the Government under the Vinson-Trammell Act have been distributed as part of profitsharing plans and are not available for repayment to the Government under the act.

THE VINSON-TRAMMELL ACT AS IMPLEMENTED BY THE PROPOSED IRS REGULATIONS

There are several hardships and inequities that arise from the IRS proposed regulations to implement the Vinson-Trammell Act. If these present proposals are adopted by the IRS and DOD in final rules, then there is an additional reason for this subcommittee to remedy the problems of Vinson-Trammell by supporting the repeal of the act. These topics are summarized below, but we request that you carefully consider the discussion in our Feb-

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ruary 26 and March 25 letters to the IRS and DOD to more fully understand the difficulties presented by the proposed IRS regulations.

One major problem arising under the proposed regulations is that they threaten to exacerbate the traceability and identification problem of the lower tier subcontractors that is inherent in the Vinson-Trammell Act. Related to the traceability problem is the problem arising due to the inadequacy of the records maintained by our member companies. For example, a February 1980 survey of the membership of the National Tooling and Machining Association showed that, although they have adequate records for tax reporting, 98 percent of the association's members do not have adequate records to supply the financial data back to October 1, 1976, necessary for Vinson-Trammell reporting.

A second major problem is that the proposed rules would require that all Vinson-Trammell reports be completed in accordance with the cost principles of the cost accounting standards and defense acquisition regulation, section XV. Because the companies forming our member associations primarily produce commercial goods, or else produce goods only under contracts that are exempt from cost accounting standards, our member companies do not have accounting systems that conform to CAS and DAR XV. A typical small businessman in this country uses a basic accounting system which tells him if he is making or losing money. It is no way remotely as sophisticated as those accounting systems required to comply with CAS and DAR XV. In fact, many of our members do not even have cost accounting systems. To comply with the proposed regulations would necessitate the complete restructuring by these companies of their accounting systems and the retroactive recreation of cost data to October 1, 1976. Moreover, certified public accountants throughout the country who audit our member companies may be unfamiliar with CAS and DAR XV.

The accounting rules in the proposed IRS regulations create an additional problem. For example, the provision in DAR XV that disallows interest expense as a cost in the determination of profits is unrealistic in today's business environment. Most of our members are required to purchase machinery and inventory on credit and, especially in light of modern day interest rates and machinery costs, interest expense is a real and necessary cost of doing business that clearly reduces a company's real profits.

Other problems with the act that directly concern our members and are more fully covered in the letter to the IRS and DOD include: the unjustified charging of interest and penalties for failure to file, the record retention requirement of the proposed rule, the definition of a complete naval vessel or military aircraft, and the unreasonable burden of proof placed on small lower tier subcontractors who place many purchase orders for less than $10,000.

Legislative Alternatives

There are several bills pending in Congress to repeal or modify Vinson-Trammell that would remove or ease the burden of Vinson-Trammell on lower tier subcontractors who are small businesses.

We support the Lugar/Cranston bill, S. 1687, which is currently pending in this subcommittee. That bill would repeal the Vinson-Trammell Act retroactively to September 30, 1976; thereby eliminating all the problems discussed in this testimony. In fairness to all businesses, this is the piece of legislation that should be passed as the Vinson-Trammell Act is unnecessary, economically burdensome, and inappropriate in today's military-industrial environment.

If it is not legislatively feasible to repeal the Vinson-Trammell Act, and remove the burdens its implementation would present, we support legislation that would effectively reduce the burden. As an alternative to repeal, we support S. 2331, which is identical to the Patterson bill (H.R. 5433), if certain changes are made to correct its problems. S. 2331 repeals the Vinson-Trammell Act retroactively to September 30, 1976, and substitutes a more reasonable contract coverage. S. 2331 creates a new profit limitation for certain prime contracts and first tier subcontracts over $5,000,000 which are awarded without competition, and therefore would effectively exempt most of our members. However, S. 2331 as currently drafted presents problems which have been discussed in previous testimony before this subcommittee, including the vagueness of certain definitions in the bill. In addition, we concur with GAO's position regarding the appropriate dollar threshold for contracts and subcontracts subject to profit limitations. GAO suggested in its testimony before this subcommittee that the dollar threshold for profit limiting legislation should be raised to $10 million and should be indexed to the rate of inflation.

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If the subcommittee finds it impractical to repeal Vinson-Trammell or adopt S. 2331, we would reluctantly support the Pell bill, S. 2232, if properly modified. The Pell bill does not change the profit limitations or reporting requirements for contracts or subcontracts covered by Vinson-Trammell, but it raises the exemption under the bill for contracts and subcontracts for military aircraft to one million dollars. We could only support the Pell bill if it were modified to increase the threshold to five million dollars and amend 10 U.S.C. § 7300 to raise the threshold for contracts and subcontracts for naval vessels, as well as aircraft. If modified, the Pell bill would eliminate a very high percentage of contracts which are not significant in size from the present Vinson-Trammell coverage and would make the administration of the act somewhat more feasible. The IRS estimates it would need 1,500 more agents to administer the Vinson-Trammell Act under its proposed rules. If modified, the Pell bill would probably reduce the number of reports by 85–90 percent and greatly reduce the Government's and industry's administrative costs. However, for contracts large enough to be covered by the Pell bill, all of the problems of Vinson-Trammell discussed above would remain; accordingly, we support the Pell bill only as a last resort if Congress feels it is necessary to continue to operate under the Vinson-Trammell Act.

Conclusion

We appreciate the opportunity to appear at these hearings to consider the troublesome issues raised by the Vinson-Trammell Act. We sincerely hope that you will recommend repeal of the Vinson-Trammell Act because it is unworkable, inequitable, and unreasonable. If repeal is not practical at this time, then we hope this subcommittee will consider the adoption of a modified version of the Patterson bill, or, if it is the only acceptable alternative, a modified form of the Pell bill in order to alleviate the difficulties of the Vinson-Trammell Act that we have discussed today. At the very least, if no legislative action to repeal or amend Vinson-Trammell is possible at this time, the effective date of the Vinson-Trammell Act reporting requirements should be suspended retroactively to October 1, 1976, and prospectively to late 1981 to provide Congress an opportunity to act on the pending legislative proposals which would repeal or amend the Vinson-Trammell Act.

We would be pleased to respond to any questions you may have concerning our testimony today.

ALLIANCE OF METALWORKING INDUSTRIES,
Washington, D.C., March 25, 1980.

DEPUTY UNDER SECRETARY OF DEFENSE (ACQUISITION POLICY),
Washington, D.C.

Attention: CPF

DEAR SIRS: This letter is written on behalf of the Alliance of Metalworking Industries in response to your request in the *Federal Register* of December 26, 1979, for written comments on the Vinson-Trammell Act.

The Alliance of Metalworking Industries consists of six member associations: the Forging Industry Association; the Metal Treating Institute; the National Screw Machine Products Association; the National Tooling and Machining Association; the American Metal Stamping Association; and the Spring Manufacturers Institute. These six associations in turn represent 4,883 separate businesses, all but approximately 2 percent of which are small businesses. The companies comprising our member associations employ 880,250 employees in a total of 19,146 separate plants, which produce combined annual sales of 34.8 billion dollars. Despite these large combined sales, the members of these six associations are small buisnesses with an average of 46 employees per plant producing average annual sales of 1.82 million dollars per plant.

We did not take advantage of the opportunity to testify at DOD's hearings on Vinson-Trammell on February 19, 1980, but two of our member associations, the National Tooling and Machining Association and the Forging Industry Association appeared at those hearings. We did, however, present our views to the Internal Revenue Service by appearing at the IRS hearings on March 12, 1980, and submitting a letter to the IRS dated February 26, 1980, with our written comments. We have attached that letter, as it explains our position

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regarding the proposed regulations, and we request that all the views in the letter be considered by DOD in formulating its position on Vinson-Trammell.

DOD Comments to the IRS

We commend DOD for the changes it has proposed to the IRS with respect to the completion of contracts and the cost of performing a contract or subcontract. However, our members are deeply concerned about many other provisions of the proposed IRS rules that are not addressed in DOD's comments. We feel that, unless DOD expresses its position on all aspects of the proposed rules, DOD may appear by implication to agree with the views of the IRS.

In the attached letter to the IRS, we have stressed the major concerns of our member associations. We believe these concerns are typical of all lower tier suppliers of defense products. Of the issues in that letter not addressed by DOD, we are most concerned about the traceability issue. We estimate that the adoption of the proposed IRS regulations would require the companies comprising our member associations to review millions of purchase orders to prepare the necessary reports from October 1, 1976, to the present. We ask you to specifically address the traceability issue in your final comments to the IRS. Under the currently proposed regulations, it would be an impossible task for our members to trace those parts subject to Vinson-Trammell, particularly on a retroactive basis.

DOD Form

We commend DOD for the simplicity of the form it has proposed for Vinson-Trammell profit reports. We also appreciate that the proposed from would relieve our members of the need to revamp their accounting systems to comply with the cost principles in the Cost Accounting Standards and Defense Acquisition Regulation, Section XV; thereby alleviating a major concern of those companies with the proposed IRS rules.

However, it is impossible for our members to respond to several provisions in the form. The request in Item 7b for the contract price of items subject to the Vinson-Trammell Act requires that subcontractors be able to make that determination. This request ignores the myriad of difficulties of traceability, that are more completely addressed in our letter to the IRS. Item 7c requires that our member companies provide the cost of the performance of items subject to the Vinson-Trammell Act. This provision has the same traceability problem as is addresed in the letter to the IRS, and it fails as well to recognize many of the costing problems addressed in that letter. For instance, there is no mechanism for the allocation for start-up costs on individual contracts for follow-on deliveries under purchase orders completed in other than the first year of a contract.

Conclusion

We thank you for the opportunity to present the views of the Alliance of Metalworking Industries with respect to DOD's comments to the IRS and DOD's proposed from. We trust that you will recognize that the repeal of the Vinson-Trammell Act is necessary, and that, if it is not repealed, logic and fairness require that it be administered in a way that minimizes the administrative burden on small contractors and subcontractors. We strongly urge DOD to withhold issuing its form and to oppose the issuance of any final rules by the IRS until such time as Congres has had the opportunity to express its position on bills pending to repeal or modify Vinson-Trammell.

Sincerely,

MARVIN R. WORTELL,
President, Alliance of Metalworking Industries.

Enclosures.

ALLIANCE OF METALWORKING INDUSTRIES,
Washington, D.C., February 26, 1980.

Hon. JEROME KURTZ,
Commissioner of Internal Revenue
Washington, D.C.

Attn: CC:LR:T (LR-71-78)

DEAR SIR: The participating associations of the Alliance of Metalworking Industries appreciate the opportunity to comment on the proposed regulations implementing the Vinson-Trammell Act of 1934, which were published in the Federal Register on October 26, 1979.

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The Alliance of Metalworking Industries represents a significant segment of our national manufacturing industry. It consists of six member associations: the Forging Industry Association; the Metal Treating Institute; the National Screw Machine Products Association; the National Tooling and Machining Association; the American Metal Stamping Association; and the Spring Manufacturers Institute. These six associations in turn represent 4,883 separate businesses. All but approximately 2% of our members are small businesses. These companies employ 880,250 employees in a total of 19,146 separate plants, all of which produce combined annual sales of 34.8 billion dollars. Despite these large combined sales, the members of the six associations are small businesses with an average of 46 employees per plant, producing average annual sales of 1.82 million dollars per plant.

In considering the adoption of any regulations implementing the Vinson-Trammell Act, you should recognize that our member associations represent companies which are typically second to fourth tier large volume suppliers of a wide variety of products used in assemblies for commercial or defense end products, including ships, aircraft, and spare parts for ships or aircraft.

Products produced by our member companies are ultimately used in defense contracts and may be subject to the Vinson-Trammell Act. Because a large but undetermined number of our members' purchase orders may have become subject to the Act subsequent to October 1, 1976, we are tremendously concerned about the extensive and costly administrative burdens created by the Act and the proposed IRS regulations, particularly the impact compliance with those regulations will have on small businesses. In several significant areas, we believe the IRS regulations actually exceed the statutory limits of the Act. We are aware of the many technical and legal problems in these proposed regulations and concur with the positions taken by the Council of Defense and Space Industry Associations (CODSIA) in its comments to the IRS regarding the proposed regulations. We understand that those comments have been submitted to the IRS.

After careful analysis of the Act, we do not see how any implementing regulations could be written that could effectively be applied to the small companies in the industries we represent. For that reason alone, we believe that the Vinson-Trammell Act of 1934 is outdated and should be repealed. IRS and DOD should not issue final regulations until Congress has had the opportunity to act on the pending legislation which would repeal or substantially modify the present Act.

Since the proposed regulations will have a specific impact on small companies represented by our member industry associations, we would like to call your attention to some of the problems created by the regulations and highlight some of the severe administrative burdens these regulations will place on the six industries which we represent.

THE PROPOSED ACCOUNTING RULES CANNOT BE IMPLEMENTED BY SMALL SUBCONTRACTORS

We believe that Section 160.9 of the proposed IRS regulations requiring the application of DAR XV and Cost Accounting Standards in establishing cost of performance is the most glaring example of the unreasonable burdens created by the regulations. Because of their small size, the companies comprising our industries may not be able to comply with the proposed accounting rules. In the event compliance is required, there will be a strong incentive for our members to refuse necessary future defense work that may be subject to the Act. The severity of the compliance problems increases due to their proposed retroactive application to purchase orders completed after October 1, 1976.

Since the majority of the sales made by the industries and companies forming our member associations are commercial, few, if any, of these companies have accounting systems that conform to DAR XV and Cost Accounting Standards, the allowable and allocable cost principles now required by the proposed IRS regulations. Furthermore, of those members doing defense work, most are presently exempt from and unfamiliar with CAS. Most of the companies comprising our members are small family-owned businesses with less than the average 46 employees, and they use a variety of accounting systems for their fixed priced purchase orders, all of which qualify for income tax purposes. However, many do not have generally accepted accounting systems which comply with government contracting policies.

In light of the fact that the Act, as now written, is applicable to all contracts over ten thousand dollars, over 19,000 companies represented by our members will be forced for the first time to adopt, retroactively and prospectively, the

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complex allocability standards of the Cost Accounting Standards Board in order to obtain a small percentage of the government defense subcontract business. This added burden will prevent these companies, comprising our member associations, from seeking government defense subcontract business since the cost of restructuring their accounting systems will far outweigh any benefits to be achieved by government contracts. We believe that it is not necessary and is inequitable to impose on small business the need to use Cost Accounting Standards for Vinson-Trammell Act reports.

While the proposed DOD approach alleviates some of the problems, we firmly believe that the Federal income tax rules would produce a more accurate statement of profits for our industries. Since DAR XV does not allow for the deduction of certain legitimate costs of doing business, such as interest expense, the application of this standard on allowable costs will result in an inflated and unrealistic profit level when, in fact, the profits realized are not so great. By applying the cost rules of DAR XV, IRS will further discourage small businesses from seeking government defense work.

Additionally, the IRS and DOD approach to contract-by-contract reporting, as set forth in the proposed regulations, would not recognize normal and traditionally recognized start-up costs. For example, the IRS regulations, as proposed, would not allow start-up costs charged to first production orders completed prior to October 1, 1976, on purchase orders entered into and completed in subsequent taxable years.

An additional problem created by the proposed accounting rules relates to their retrocative application. By forcing the members of our associations to now provide cost information for hundreds of thousands of orders completed after October 1, 1976, the IRS is unjustifiably penalizing our members who, in the absence of any directions from the Government, have used their traditionally acceptable accounting methods in identifying costs and profits on individual purchase orders. To now impose such a burden on these companies is unreasonable, since they would have to retroactively reconstruct and modify their accounting systems to comply with these new accounting rules.

We believe that should this retroactive application of the accounting rules be retained in the final rules, virtually none of the companies comprising our member associations could successfully and accurately account for costs and profits of those purchase orders subject to the Act. The administrative burden would be so extensive and costly that it would seriously impair their ability to continue functioning on a daily basis.

INTEREST AND PENALTIES SHOULD NOT BE APPLIED UNTIL FINAL REGULATIONS ARE ADOPTED

IRS is not required by the Act to impose interest or penalties on contractors who have not filed due to the lack of any government regulations. It is an unreasonable requirement to impose these sanctions when final regulations have not been published. If it were possible to identify the profits on individual purchase orders, a company would be required, under Section 160.19, to repay excess profits with interest. Imposing interest and penalties on those excess profits not paid would create an intolerable burden. Since the IRS interest charge has increased from 6% to 12%, the financial burden could impair the future business operations of these small companies.

IT IS IMPOSSIBLE TO IDENTIFY OR TRACE PARTS WHICH MAY BE SUBJECT TO THE REGULATIONS UNDER THE PROPOSED DEFINITION

Section 160.1(k) defines a portion of a new complete naval vessel or military aircraft as "any material or article that forms a part of a complete naval vessel or military aircraft and has been furnished under a mutual understanding that it is to form such a part."

Since most of the companies comprising our membership are third and fourth tier subcontractors, making tens of thousands of parts used in both commercial and defense end products, it will be impossible for these companies to identify or trace the parts they have produced through the various higher subcontracting tiers, manufacturing levels, and assembly processes in order to ascertain whether that individual part, produced under purchase orders, ultimately became part of a completed new naval vessel or military aircraft. As discussed previously, to now identify hundreds of thousands of small purchase orders for millions of parts in contracts that the companies comprising our member associations have

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entered into since October 1, 1976, is an impossible task. Since these companies, their customers, and their suppliers did not have knowledge that the IRS and DOD intended to promulgate a regulation based on a determination of the end use of the part, the identification of the ultimate end use of each part has not been considered as necessary for the past three and one-half years. To impose liability for failure to collect information when these companies were not aware that such reports would now be required is unconscionable. Because of the extensive quantities and variety of parts produced by these companies since October 1, 1976, it would be exceedingly time consuming and expensive for them to even attempt to trace each forging, stamped part, machined part, or spring produced under individual subcontracts or purchase orders to its ultimate end use, assuming that such tasks are even possible.

Even if the retroactive application of the Act was eliminated in the regulations, the prospective tracing of end uses would be extremely difficult. As previously noted, the companies comprising our member organizations are generally second to fourth tier subcontractors. It would be necessary for them to trace each part through upper tier subcontractors and then through the prime contractor to determine if the end use of the part was incorporated in a completed ship or aircraft or a spare part. As mentioned previously, many of the products produced by these companies are sold to companies which may be included in either military or commercial end products. The proposed regulations do not address or correct this traceability problem. Because of this complexity, no final regulations should be published and no reports required until lower tier small business subcontractors are provided with workable, practical and efficient directions to trace the end use of their products, subject to the Act.

In proposed Section 160.12, subcontractors would be required to pass the Vinson-Trammell clause down to all levels of subcontractors. This is an unwarranted extension of the Act to third, fourth, or lower tier suppliers. In our industries, it will produce confusion, and may very well create difficulties for those companies who are suppliers of materials. Many of our companies will be unable to identify which of their supplier's purchase orders exceeding $10,000 were for material which became a part subject to the reporting requirements of the Act and the proposed regulations. In addition to these supplier identification problems, few of our member companies have the required clause in their past and present supplier contracts.

RECORDS RETENTION REQUIREMENTS ARE NOT PRACTICAL

Section 160.14(b) requires preservation of all relevant records until the IRS deems them no longer material to the administration of the Act. Since there had been no requirement of retaining records from the past three and a half years, many of the companies comprising our member associations have disposed of the records now required by the IRS and DOD. To impose liability under the proposed regulations for such a failure to retain these records when there was no indication that they would be required is unjustified.

In addition to this retroactive requirement, this section concerns us because it imposes open-ended requirements for the future preservation of records. Such a requirement is an undue and expensive burden for small companies. We see no reason why the proposed requirements under this section must exceed the General Accounting Office and the IRS rules for retention of records for tax purposes. We urge that alternatives be considered in place of this open-ended requirement. Amending this section of the proposed regulations will provide greater certainty for the vast number of companies who may be subject to the Act and final regulations.

DEFINITION OF A COMPLETE NAVAL VESSEL OR MILITARY AIRCRAFT GOES BEYOND THE SCOPE OF THE ACT

Because the companies comprising our member associations produce parts, many of which are not integral parts of the naval vessel or aircraft, we are concerned that the proposed definition in Section 160.1(b) are too vague. Defining a complete naval vessel or military aircraft to include "all articles necessary for the performance of its intended service" improperly expands the coverage of the Act and imposes unwarranted identification burdens on lower tier subcontractors.

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PLACING THE BURDEN OF PROOF ON SMALL LOWER TIER SUBCONTRACTORS IS AN IMPROPER EXTENSION OF THE REQUIREMENTS OF THE ACT

Since the companies comprising the member associations produce a variety of parts under hundreds of thousands of purchase orders varying in amounts, but generally under $25,000, we are concerned that section 160.3 of the proposed regulations is unworkable for our industries. As written, that section would place the burden of proof on these companies to demonstrate that purchase orders for parts under $10,000, which aggregate more than $10,000, were not separated merely to circumvent the Act. Such a requirement once again places a severe administrative burden on small companies and should be deleted. If this proposed requirement is applied to purchase orders completed over the past three and a half years, our member companies could not meet the burden of proof and many purchase orders under $10,000 would then be subject to reporting. This is an improper extension of the requirements of the Act. If the IRS had to impose such a harsh burden, it should have made it known at the time the Vinson-Trammell Act became operative in October, 1976.

CONCLUSION

The Alliance of Metalworking Industries sincerely hopes that the IRS recognizes that the proposed regulations in their present form impose, at virtually every point, severe and substantial administrative burdens on our members' industries, particularly in view of the fact that they are small businesses and lower tier subcontractors. We request that the IRS, for the reasons stated above, recognize that the repeal of the Act is necessary. We further request that the IRS withhold issuing any final rules until Congress has had an opportunity to express its position on the bills pending to repeal or modify the Vinson-Trammell Act.

Should the IRS schedule any public hearings, we request the opportunity to further develop our position at such hearings.

Sincerely,

MARVIN R. WORTELL,
President, Alliance of Metalworking Industries.

Senator MORGAN. As far as I can see from what I have, we have everything we need, but as we review it, we may find something else.

Thank you all for coming. The hour is late. We will adjourn.

[Whereupon, at 4:50 p.m., the subcommittee was adjourned, subject to the call of the Chair.]

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